

S. HRG. 108-1028

ESCALATING CABLE RATES: CAUSES AND POTENTIAL SOLUTIONS

HEARING

BEFORE THE

COMMITTEE ON COMMERCE,
SCIENCE, AND TRANSPORTATION
UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

MARCH 25, 2004

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SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED EIGHTH CONGRESS

SECOND SESSION

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ESCALATING CABLE RATES: CAUSES AND POTENTIAL SOLUTIONS

THURSDAY, MARCH 25, 2004

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Committee met, pursuant to notice, at 9:32 a.m. in room SR-253, Russell Senate Office Building, Hon. John McCain, Chairman of the Committee, presiding.

OPENING STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

The CHAIRMAN. Good morning. Today the Committee examines the continued escalation of cable rates, everybody's favorite topics. The FCC's most recent report found the overall average monthly rate for consumers subscribing to a cable or satellite service increased 8.2 percent from 2002 to 2003. Since 1996, cable rates have increased 56 percent, or nearly three times the rate of inflation.

In order to better understand the cause of soaring cable rates, I asked the General Accounting Office to conduct a review of these increases. GAO released its report last fall and its principal finding was not surprising. Competition matters.

As stated in the first sentence of the report, quote, "competition leads to lower cable rates and improved quality." You know, Senator Burns, I'm not sure if that's a viable use of taxpayer dollars to come up with such a profound statement that competition leads to lower cable rates and improved quality.

Anyway, more surprising though was the significant impact that competition from a wired competitor has on cable rates and the insignificant impact competition from satellite television has on these rates. The GAO report found that competition from another wired competitor resulted in the incumbent cable operator's rates being 15 percent lower. A subsequent study from GAO suggests that in some markets the presence of wired competitor may reduce rates an astounding 41 percent. By contrast, GAO concluded that satellite service has a minimal effect on lowering incumbent cable prices.

Unfortunately, only 2 percent of all markets have a wired competitor. But the implication of these findings is that incumbent cable companies face little price competition and 98 percent of consumers are being taken to the cleaners as a result. I look forward to hearing suggestions today about whether there are barriers to entry that need to be addressed to facilitate more competition to

cable. But we must also consider other solutions that will give consumers more control over how they purchase video services.

When it comes to purchasing cable channels beyond the basic tier today, consumers have all the choice of a Soviet election ballot. One option, take it or leave it. You want ESPN, you must buy 40-plus channels of expanded basic. You want CNN, you must buy 40-plus channels of expanded basic. You want Comedy Central, well you get the idea.

This dearth of choice comes from an industry that has proclaimed its indignation at the injustice of being forced to carry unwanted broadcast stations. The cable industry challenged the so-called must-carry rules of the 1992 Cable Act to the Supreme Court. Today it's arguing at the FCC about the gross inequity that would result from cable systems being forced to carry unwanted digital channels under a multicast must-carry regime, while the current must-purchase regime for consumers is equally unfair. So I encourage the industry to find a consistent message for itself. If they want choices, provide the same choices to your consumers.

Not surprisingly, cable channels argue that giving consumers more choice over what they purchase is threatening to their respective business plans. Any business that has the benefit of conscripted purchasers would be foolish to give up that guaranteed revenue, but in a free market, sellers must convince buyers to purchase their services. There are no guarantees.

Moreover, no one has suggested that cable companies should be prohibited from continuing to offer an expanded basis tier. An à la carte pricing model would merely add more pricing choices for consumers. The cable industry regularly touts the value its expanded basic tier delivers to consumers, noting that it, quote, costs less than taking a family of four to a movie or a professional sporting event. If the expanded basic tier is of such great value, then one would expect few consumers to choose per-channel pricing, and the Chicken Little predictions from the industry about the impact of expanding consumer choice should prove baseless.

If, on the other hand, consumers reject the expanded basic tier in large numbers, then it would demonstrate that today's must-purchase regime is unfair to consumers. Just yesterday, consumer choice was dealt another blow. Although a reported 91 percent of Cablevision customers chose not to purchase the Yes Network when given the choice last year, an arbitrator's decision will compel all expanded basic customers to take the channel. And, as one would expect, the rates of these subscribers will go up.

If anyone doubts the public interest in more choice, then I should read the correspondence that comes into my office. A few months ago I received an e-mail from a gentleman who wrote, and I quote, a year ago I had 40 channels and was happy. Then my cable company rewired the town. No one asked them to do it. Then they increased our channels to 70. No one asked them to do it. Then they doubled our rate. They said take it or leave it. I asked for the 40 channels back and a lower bill. They said no. I'd like the idea of à la carte.

We'll certainly have more discussion on this issue today. I thank the witnesses for being here and I would also like to include for the record a letter addressed to me from the Parents Television Coun-

cil, who are strongly in favor of the à la carte system because of the aspect of indecency. And they raise a legitimate question, is that the cable companies proudly announce that they will be providing easier ways to block channels that they don't want their children to see, yet subscribers are still paying for the channel.

Senator Wyden.

[The prepared statement of Senator McCain follows:]

PREPARED STATEMENT OF HON. JOHN MCCAIN, U.S. SENATOR FROM ARIZONA

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More surprising was the significant impact that competition from a wired competitor has on cable rates, and the insignificant impact competition from satellite television has on these rates. The GAO report found that competition from another *wired* competitor resulted in the incumbent cable operator's rates being 15 percent lower. A subsequent study from GAO suggests that in some markets the presence of wired competitor may reduce rates an astounding 41 percent. By contrast, GAO concluded that satellite service has a minimal effect on lowering incumbent cable prices.

Unfortunately, only 2 percent of all markets have a *wired* competitor. But the implication of these findings is that incumbent cable companies face little price competition, and 98 percent of consumers are being taken to the cleaners as a result.

I look forward to hearing suggestions today about whether there are barriers to entry that need to be addressed to facilitate more competition to cable. But we must also consider other solutions that will give consumers more control over how they purchase video services.

When it comes to purchasing cable channels beyond the basic tier today, consumers have all the "choice" of a Soviet election ballot. One option take it or leave it. You want ESPN? You must buy 40-plus channels of expanded basic. You want CNN? You must buy 40-plus channels of expanded basic. You want Comedy Central? Well, you get the idea.

This dearth of choice comes from an industry that has proclaimed its indignation at the injustice of being forced to carry "unwanted" broadcast stations. The cable industry challenged the so-called "must carry" rules of the 1992 Cable Act to the Supreme Court. Today it is arguing at the FCC about the gross inequity that would result from cable systems being forced to carry unwanted digital channels under a "multicast must carry" regime. Well, the current "must purchase" regime for consumers is equally unfair. So, I encourage the industry to find a consistent message for itself—if they want choices, provide the same choices to your customers.

Not surprisingly, cable channels argue that giving consumers more choice over what they purchase is threatening to their respective business plans. Any business that has the benefit of conscripted purchasers would be foolish to give up that guaranteed revenue. But in a free market, sellers must convince buyers to purchase their services. There are no guarantees.

Moreover, no one has suggested that cable companies should be prohibited from continuing to offer an expanded basic tier. An à la carte pricing model would merely add more pricing choices for consumers. The cable industry regularly touts the value its expanded basic tier delivers to consumers noting that it "costs less than taking a family of four to a movie or professional sporting event." If the expanded basic tier is such a great value, then one would expect few consumers to choose per-channel pricing, and the "chicken little" predictions from the industry about the impact of expanding consumer choice should prove baseless. If, on the other hand, consumers reject the expanded basic tier in large numbers, then it would demonstrate that today's "must purchase" regime is unfair to consumers.

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We will certainly have more discussion on this issue today. I thank the witnesses for being here.

Senator WYDEN. Mr. Chairman, thank you. If I could go after Senator Burns, I know he's got a tight schedule and——

The CHAIRMAN. As long as we can keep Senator Burns from appropriating, the more taxpayers are safe.

[Laughter.]

Senator WYDEN. I will pass on the chance to be part of that debate.

The CHAIRMAN. Senator Burns.

**STATEMENT OF HON. CONRAD BURNS,
U.S. SENATOR FROM MONTANA**

Senator BURNS. Thank you very much, Mr. Chairman, and thanks for holding this hearing today, and I apologize. I'll make my statement and then move along. I do have the Secretary of the Interior coming up today, one of your favorite persons, and we'll try to hold everything in due bounds, and by the way, when you were talking about à la carte, the last time we were talking about that we mentioned something in the *Style* section of the *Washington Post*. Is there anything—and I noticed the press table back there immediately went to the *Style* section whenever it started to be—was used as a prop on that day and I don't know what's in there today, but if there's something in there we'll get the press to start reading the paper and doing things like that.

I ultimately—I'm going to go along with that high-priced report saying market discipline imposed by competition is far more effective in protecting consumers than any government regulation. And we paid quite a lot for that report and so I, maybe right now I concur, it's probably worth the money.

Competition does force companies to innovate in order to keep their customers and attract new ones. Right now you know the cable industry has expended about, since 1996 over \$80 billion to upgrade its systems to do, in order to compete with a host of not only information services, but what we get in our news and also offering high-speed services into areas where they never had broadband access services before.

So I'm pleased that there's a healthy competition in multi-channel video services in my state of Montana. A decade ago, if Montana had problems with their cable service, they really didn't have a good alternative, but that's not the case today. Echostar, DirecTV offer over 500 channels of digital video and CD-quality music. In fact, close to 40 percent in Montana households subscribe to a direct broadcast satellite service.

Even though cable doesn't reach every household in Montana, where cable is deployed it competes head to head with satellite pro-

viders. The competition makes certain that my constituents do have a choice.

In Montana, we've benefited greatly by—we have a new owner now of the systems up there that bought out all the AT&T systems. The commitment that they have made to Montana to deliver new services and to compete in other areas is really a breath of fresh air in our state.

Like others in the cable industry who have invested billions of private risk capital to upgrade the digital, the people are making significant investments in the system that they purchased in Montana and they're—as they move forward.

I'm concerned about, however, the perception that government is considering new regulations on cable service that would be enough to make an already tight capital market dry up. Right now on expansion capital investments and the capital—the money markets, low interest rates are providing an opportunity to move forward on new and improved services. Without access to affordable capital, making these investments necessary to upgrade cable systems would not be possible. It just takes good old hard money.

I'd like to address the idea of the à la carte requirement on cable operators. I have serious reservations about that. The wisdom of mandating such a system on an à la carte approach, many of the most popular and compelling content available on cable would no longer exist. We wouldn't see Biography or National Geographic, A&E, Discovery, or dozens of other networks. They would struggle and probably some would fail. Each network has a loyal following, but as a stand-alone service, their revenue would also suffer and the price to sustain that service would be too high.

Many of these channels depend on advertising revenue. I can remember I bought cable 100 years ago, well it wasn't quite that long ago but it seems like it, because there wasn't any advertising on it, and guess what? We got advertising on it. But nonetheless, that's the way it goes and out of that industry I can also understand that.

But many of these channels depend on advertising revenue for two-thirds of their revenue streams. In fact, these channels could not even be initially launched under an à la carte system, so the current system model of cable programming, which has allowed these channels to find an audience and eventually reach a national critical mass of subscribers which advertisers demand would be completely undermined by that system.

As I've said before, cable offers a product just like any other newspaper. I buy the *Billings Gazette* reluctantly, no not really. Well, they, you know, I only—I may read only the business section, my neighbor may only read the sports section, but I don't expect to be able to buy just the business section on its own. Newspapers rely on different content to attract the broadest audience possible so they can maximize their advertising revenue. The broadcast industry is no different.

If newspapers were required to sort out their different sections, I'm sure that we would see a difference in the cost of what we pay for newspapers and also what we pay for advertising. So I think we should look at this. It's a great populist idea, but it may be an idea that has a hard time—and my Blackberry, that's really my

pacemaker, going off here—enterprising system and I think throughout the country.

And also, you know, I know there are a lot of people that look upon the cable industry as a utility, and we don't want to get too far afield in that kind of thinking, because it is a service. So without government involvement, the cable industry has really evolved into a huge industry. Today consumers have probably more selection of what they want to watch, who they want to hear, and what they want to learn than any time in the broadcast industry. If we disrupt that economic model, I'm afraid—that foster the development of hundreds of channels available today, the impact on consumers would be immediate and I think it would not be good.

So, Mr. Chairman, thank you for holding this hearing. I've got to go over and leave. I apologize that my presence will be missed here, I know, but nevertheless I have other duties to take care of. And thank you, I want to thank my good friend from Oregon for allowing me to proceed, and thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I would request that my colleagues make their opening statements as brief as possible. We have—

Senator BURNS. I'm done.

[Laughter.]

Senator BURNS. I got my plow out of the ground.

The CHAIRMAN. Thank you. Senator Wyden.

STATEMENT OF HON. RON WYDEN, U.S. SENATOR FROM OREGON

Senator WYDEN. Thank you, Mr. Chairman, and it just seems to me it's not going to be acceptable to consumers to find that every time they turn around cable rates go up, triple the rate of inflation. And consumers keep waiting for prices to level off somehow, and instead, millions of our consumers are being force-fed new channels and new features that certainly many don't want.

And I looked at the GAO report in some detail and there are some important issues that need to be examined with respect to à la carte offerings. For example, the GAO report says that a basic cable package today averages around 25 channels. The next tier up, expanded basis, averages about 36 more. So that is a pretty big jump from 25 straight to 61. And right now a consumer must choose one or the other and isn't free to decide which particular channels would be included in either package.

So it seems to me that even if you didn't go to some of the full à la carte pricing options that have generated so much industry opposition, it ought to be possible to provide consumers with a broader range of choices and still more stable pricing. And my sense is that the ball is in the industry's court right now. If the industry continually makes the argument, look, you're not going to have these additional channels that you want for, say, programming that's important for a minority group, something I support, without all these extra prices, a lot of us aren't going to swallow that argument anymore.

I think it's our view that the industry has sufficient technological expertise and business savvy to figure out a way working with the Congress of the United States to make sure that people are in a

position to decide for themselves what choices they want or whether they want more channels and the additional prices.

So I think it's important that we go through some of the technical issues this morning, Mr. Chairman. Certainly the technical barriers to à la carte ought to be shrinking. The GAO notes that advanced converter boxes and TVs with built-in converter box capability are growing. More common to some of the issues to à la carte pricing seem to be moving in the direction of consumer choice.

I'm glad you're holding this hearing. I look forward to working with you and people from a variety of positions on this to figure out a way so we can align the choices people want in this country to prices they can afford, and I thank you.

The CHAIRMAN. Senator Lott.

**STATEMENT OF HON. TRENT LOTT,
U.S. SENATOR FROM MISSISSIPPI**

Senator LOTT. Thank you, Mr. Chairman. Thanks for having this hearing, and I have a prepared statement I'd like to actually put into the record.

The CHAIRMAN. Without objection.

Senator LOTT. Mr. Chairman, also I would like to take just a moment to recognize the fact that we had the 25th anniversary of C-SPAN last week, March 19, and C-SPAN, I believe, has been a tremendous facilitator of public discourse, has given people access to what we are doing. Sometimes it amazes me when I talk to people and they say, well, I just saw somebody speaking on C-SPAN. They actually watched the debate in the Senate. That's pretty spooky.

But I think C-SPAN has done a tremendous job. I think the cable industry deserves credit for carrying it over these years, and I hope it has many years of success to come.

My relationship with cable goes back to 1967 when I tried to get a cable franchise in my home area in Mississippi. It was opposed, I remember, by the local radio station, who wound up eventually getting the franchise after I left to come to Washington. I think cable has done a tremendous job and we want to work with you to make sure that you continue to provide this great service to the people for a profit.

But I also have to tell you, you better listen to the constituents or you're going to have trouble. We've gone through this before. When your rates get too high, and you start acting irresponsible, we regulate you. When we regulate you, that is not a good idea. It limits what you can do, and then we come along and we deregulate you.

But I've always tried to warn the cable industry there is a point when people will rebel. They will only pay so much, and once you get up over that level, you're going to have trouble, because they're going to holler at us and then we're going to take it out on you. And I think you're knocking on that door.

You need to also remember that television is now like telephones used to be. It's a part of—people feel like it's theirs, they own it. It's a part of their psyche. They're attached to it. And if you don't give them good service that's affordable and flexible, they're going

to look for other competitors, and I think cable is underestimating some of the competition they're going to have in the future.

So my first word of caution is to you, do something about your rising rates or you're going to have trouble. And second, I don't like mandating the à la carte option. You ought to do it. People want that. Put yourself in their shoes. Use common sense. I have all these channels that I get here in the District of Columbia and I should—I'd like to obliterate 100 of them. And I also think that ESPN, the sports people, if they don't start getting their charges under control to pay salaries that are ridiculous, you're going to have an explosion on your hands with the American people there too. We'll only go so far to watch a football game, and I think that you're pushing the limits.

So my reason for being here is that I do think this is an important industry, it's a dynamic, changing industry. You have to be prepared to change with it. You better pay attention to your competition, you better pay attention to what you charge, and you better pay attention to what you make available to the people. This is fair warning. I'm not prepared to mandate or regulate rates now or à la carte options, but if you don't do something about it, we will.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Breaux.

**STATEMENT OF HON. JOHN B. BREAUx,
U.S. SENATOR FROM LOUISIANA**

Senator BREAUx. Thank you, Mr. Chairman. Sounds like my good Republican colleague from Mississippi was arguing for price controls for the NBA and NFL.

Senator LOTT. Well, they need to control themselves. In a free enterprise system you exercise restraint or you get into trouble and that is democracy.

Senator BREAUx. Thank you, Mr. Chairman, for having the hearing. This Committee has been doing a lot of work this week. We've had a number of very significant hearings and I think this is one too.

I question the premise that in a competitive world it is an appropriate role of Congress to regulate prices. We made a decision in 1996 the cable industry had competition and it was no longer necessary to regulate the rates that they charged because of the advent of direct broadcasting and other competitive models. We find today that about 75 percent of the viewers of cable and about 25 percent of direct broadcasting services determine how people view what comes into their homes, and Congress has made a decision that is competition.

I think there's a legitimate role for Congress to regulate monopolies. I mean, that's the essence of what we should do. If there's only one provider of one particular service, whether it's energy or transportation or television or what have you, there's a legitimate role for Congress to be involved in setting prices when there is a monopoly.

But Congress has made a decision that in this area there is not a monopoly. We made a decision not to regulate rates. The question now becomes whether we should maybe not regulate rates but we

should regulate the method of which people sell their products. I think Senator Conrad was talking about, do we mandate that newspapers don't sell the sport page because maybe some people don't watch it, or maybe sell only the money section of the paper because somebody would want that. No. I mean, that's up to the private sector to go out and do and market their products.

I mean, the à la carte, I think it would be presumptuous to say that Congress should tell this industry how they should market their products and that they have to give it under an à la carte type of basis as opposed to packing the deals. I think the idea even from my perspective indicates some problems that other channels would end up paying substantially more if in fact that was the case.

So I think it's good to have this hearing. I hope we have some good discussions about my concerns that I've expressed and look forward to the witnesses.

The CHAIRMAN. Senator Brownback.

**STATEMENT OF HON. SAM BROWNBACK,
U.S. SENATOR FROM KANSAS**

Senator BROWNBACK. Thank you, Mr. Chairman, for holding the hearing. I want to put my full statement into the record.

The CHAIRMAN. Without objection.

Senator BROWNBACK. A couple of quick thoughts. I find the GAO report quite actually reassuring but not all that surprising in their finding that, this is a quote, from competition from wire-based and direct satellite, broadcast satellite operators, leads to lower cable rates, improved quality and service on cable operators. That's competition. I think that's the way to go.

In following up on what Senator Breaux said though, I want to make two thoughts to the cable industry if I could. One is, the Parents Television Council, and the Chairman has just provided this letter to me, is pressing, and this is a group that I've supported and worked with for some time, saying why do you have to, if you want good homes, if you want *Better Homes and Gardens*, why do you have to take *Playboy* as well? And I don't know that that's a forced pairing that people have to take, but there is—there are pairings that are occurring that people don't like. And I would hope the cable industry would look at that and maybe again reflect on what are you forcing together here and are there ways that you can put the packages together differently that people could have options that they would find more palatable to them.

And I'm just, I'm asking to look at that again. And I know you're constantly probably reviewing those sort of packages. If you could look at that, it would be helpful.

I would note as well, because of the indecency bill that we've got moving forward and the very strong interest on cable being a part of that, I had a meeting with some of the cable groups saying that, well, we're going to look at what we can do internally to do self-regulation on decency material. I would urge that forward as well so that people within the industry would start to address these issues of decency that I think most people, 75, 80 percent, maybe more, people get their television through cable looking at it as nearly that ubiquitous way of receiving television that was the rea-

son that was given by the Supreme Court previously not to have cable regulated similarly. It wasn't ubiquitous. You're getting close to having that standard now.

I think these would be very helpful if the industry would voluntarily address some of these indecency issues on their self-regulation, would be a positive move to take forward and hopefully that will move forward.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Inouye.

**STATEMENT OF DANIEL K. INOUE,
U.S. SENATOR FROM HAWAII**

Senator INOUE. Thank you very much, Mr. Chairman. I have a prepared statement.

The CHAIRMAN. Without objection, it'll be in the record.

Senator INOUE. I'm just wondering, Mr. Chairman, if we began regulating rates, what will happen to programs like C-SPAN, which they are now supporting? And I guess less than 1 percent of the population would watch that, and if we have it à la carte, how many people will take C-SPAN? And yet we know that it's an important part of democracy. Many other programs of that nature.

And so I'm going to be listening, sir. Thank you.

[The prepared statement of Senator Inouye follows:]

PREPARED STATEMENT OF HON. DANIEL K. INOUE, U.S. SENATOR FROM HAWAII

This hearing presents the Committee with an important opportunity to examine some of the root causes of increasing cable rates, their impact on consumers, and possible solutions. We are all well aware of the troubling trend of cable rates increasing faster than the rate of inflation. The more difficult task we face, however, is identifying a reasonable and effective solution. Any solution must ensure that the cable industry continues to have the resources to make the investments necessary to deliver a full array of video, Internet, and competitive voice services, while also ensuring that all cable customers receive high quality services at reasonable prices.

In order to offer consumers new and innovative video and non-video services, to their credit, cable companies have invested more than \$75 billion to upgrade their systems. But clearly cable customers should not shoulder the burden of non-video investment costs in their monthly cable bill. Marketplace, or if necessary, regulatory solutions may be required to create a business model that encourages investment and still gives customers value for the services they purchase.

Additionally, higher programming costs and investment expenditures have contributed to higher cable rates. In order to bring consumers the sports and entertainment programming they want to see, cable companies have had to pay higher programming costs. According to the General Accounting Office, between 1999 and 2002, programming costs increased approximately 48 percent. Sports programming costs alone increased 59 percent.

A concept that has recently garnered interest would rethink cable's existing business model. In the name of consumer choice and lower prices, some have proposed adopting an "à la carte" approach that would empower consumers to choose which channels they want to receive and pay for. Today, consumers can choose what they want to watch from a menu of hundreds of channels, but they are required to pay for all of them.

At first blush, consumers has simple appeal. However, before moving forward, we must answer this question: "Will a new model actually result in more consumer choice and control at lower prices or less choice at higher prices as niche channels go dark, new channels fail to launch, and surviving channels cost more?"

I do not have the answer, but I am concerned that pursuing an "à la carte" approach may cause more problems than it solves. If existing competition from Direct Broadcast Satellite and cable overbuilders has failed to place adequate downward pressure on cable prices, perhaps creating incentives to encourage competition would be a more prudent option.

I look forward to the testimony of the panel.

The CHAIRMAN. Thank you, sir. Senator Stevens.

**STATEMENT OF HON. TED STEVENS,
U.S. SENATOR FROM ALASKA**

Senator STEVENS. Mr. Chairman, I thank you for the hearing. I have three other hearings but I did want to come by and express my point of view that I am troubled about the growing concern of the consumers that they have to buy packages that contain materials they don't want. I share Senator Brownback's point of view and really share the point of view expressed by Senator Lott and Senator Breaux.

It does seem either there are two new elements at play here. One is the industry's new announcement, and the second is the developing digital cable market-driven solutions. I think on the Internet now you can pull down song-by-song for a very small cost. It used to be you had to buy a package. I think as the demand comes and as these concerns are heard by the industry, competition will bring about some change. I hope it does.

I do hope the industry's listening though, because those market-driven solutions have to come along pretty fast or Congress will have to act.

Last, I will say, if you haven't visited the home of the future that Microsoft has got out in Seattle, you certainly ought to go do it, because if that is the future, it is totally digital-driven living and personal solution of every type of application you can think of at a small fee that the homeowner will pay. And I think if competition will take us sooner to that solution where we have really total personal choice at a cost that is less than these packages today, that is the ultimate solution that will benefit the American consumer. Thank you very much.

The CHAIRMAN. Senator Lautenberg.

**STATEMENT OF HON. FRANK R. LAUTENBERG,
U.S. SENATOR FROM NEW JERSEY**

Senator LAUTENBERG. Thank you, Mr. Chairman. The issue that we're discussing today is very important to my constituents in New Jersey and I'm sure that's reflected across the country. I don't hear as much about the highlighted issues like gay marriage or immunity to gun manufacturers dealers as I do about the increasing cost of cable service. Letters from cable consumers complaining about rapid price increase in the cost of cable service have been streaming into my office, and I believe that the people who write to me have good reason to be upset.

And it's important here to distinguish between the so-called basic and expanded basic cable programming packages. According to the New Jersey Board of Public Utilities, the average cost of basic, which is regulated by the state, has actually decreased from \$13.23 in 1999 to \$12.44 in March 2004. The rate for this stable 27 channels on basic is in stark contrast to the 75 percent increase in the price for expanded basic service, which has great appeal for lots of people. From March 1999 to today, the price for expanded basic grew from \$17.76 a month to \$31.09 a month. Consumers are rightfully upset.

The cable industry has argued that such an increase is justified given the industry's massive capital investment in network infrastructure improvements. And while these improvements provide consumers with new, enhanced services, a greater number of video channels and high-speed Internet access and telephony, I know also that the cable companies point to significant increases in the cost of programming, particularly sports programs.

And I grant these arguments, but I wonder why, if they're true, that the cable companies don't give the consumers greater flexibility to choose and pay for the channels that they prefer to watch. A pure à la carte pricing structure has its own problems. Some shows just many not generate the audience, and I've had discussions with many of the people from the industry, necessary to sustain them. But I believe that the industry could show leadership in this area and develop price structures that give consumers more choices, translating that into lower, not higher rates.

And I want to credit the industry, leaders like Robert Sachs from the National Cable Television Association, cable executives like Brian Roberts of Comcast, and today's witness, James Robbins of Cox Communications, for making it easier for consumers to block unwanted channels. That's a good first step.

The logical next step is to relieve consumers of the burden or paying for lots of channels that they don't want, and I encourage the industry to diversity in pricing, just as it has diversified programming.

Thanks, Mr. Chairman.

The CHAIRMAN. Senator Smith.

**STATEMENT OF HON. GORDON H. SMITH,
U.S. SENATOR FROM OREGON**

Senator SMITH. Thank you, Senator McCain, Mr. Chairman. I'd like to put my full statement in the record if I may.

The CHAIRMAN. Without objection.

Senator SMITH. And simply summarize my observation that as a consumer of television, I'm amazed at the amount of competition, assaults on cable, and I think far better than we to regulate how they market competition will ultimately drive this better than we can.

I join in Senator Brownback's concern about bundling things which are out of category or inappropriately bundled, but I also want to say that, and it may not be a perfect analogy, but if the Federal Government told me that in order to sell Campbell's Soup I had to sell 30 million pounds of peas before I could sell 20 million pounds of corn, it would be a terrible distortion of a marketplace, and I think these men and women of cable are—I think are getting the message, but I think understanding what you bundle and how you market and how you make their bottom line is important for us to permit and then watch the marketplace work, because it will do a better job than we can.

And so, with that, Mr. Chairman, I'll include my statement in the record and listen with interest to this discussion.

The CHAIRMAN. Thank you. Senator Nelson.

**STATEMENT OF HON. BILL NELSON,
U.S. SENATOR FROM FLORIDA**

Senator NELSON. Thank you, Mr. Chairman. Cable rates certainly deserve the close scrutiny of this committee. It's up to us to help make sure that the cable customers are getting their money's worth. There are clear reasons why the cable prices have risen. The industry has invested \$70 billion in the modern infrastructure. Cable's now the leading provider of high-speed Internet and it's beginning to offer the voice over.

The cable industry is also paying greater costs to secure the programming, but we need to ask ourselves whether these substantial costs justify the rapidly rising rates that are being charged to the customers.

And then, on the question of à la carte, I am naturally inclined to want to keep a package because of threatening the viability of the cable industry, but I think back to the first experience that I had when I was in the House of Representatives, my home town of Melbourne, Florida, was chosen as the pilot project to run the raunchiest cable program on the Playboy channel. And I said, why Melbourne, Florida? The customers had no choice and I couldn't get any satisfaction back then. Ultimately it had such a public outcry that it was offered more as an extra instead of the regular basic package, but I must say that concerns me.

Thank you.

The CHAIRMAN. Senator Allen. I would remind my colleagues we're 40 minutes now into the hearing and we are not finished with opening statements.

**STATEMENT OF HON. GEORGE ALLEN,
U.S. SENATOR FROM VIRGINIA**

Senator ALLEN. Thank you for your patience, Mr. Chairman. I look forward to this hearing as well. We all are going to examine why cable prices have increased over time. A lot of it is because of their investment. The cost of programming, obviously, if it's positive, popular such as ESPN, those sports teams are paying their athletes salaries and so that's going to go up, but it's also popular and good for advertising revenues.

I would also like to point out a lot of advancements in addition to the programming options and news and greater sports and other entertainment is that there are better quality opportunities in advanced services, whether that is the Internet, the broadband Internet access, high definition TV, and other services.

And I, Mr. Chairman, I'll just put my statement in the record. The issue of à la carte I think as an instinctive people like it initially. Then I do think we need to examine though what the impact of that would be on prices, and I look forward to listening to our witnesses, who, and in my view, we do have more competition, because not only is cable a cable, but also satellite.

And as these substantial investments go forward, and I think it's one of the more positive aspects of the communications, economic sector, let's make sure that what we're doing is appropriate to make sure that the programming is diverse, available, and affordable, and I thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Rockefeller.

Senator ROCKEFELLER. Mr. Chairman, What we will be hearing this morning is of great importance to the people of West Virginia.

The CHAIRMAN. Thank you very much, Senator Rockefeller.

Mr. Mark Goldstein is the Director of Physical Infrastructure Issues at GAO. He's our first witness. And for the record, Mr. Goldstein, you might mention who is accompanying you.

STATEMENT OF MARK L. GOLDSTEIN, DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY AMY ABRAMOWITZ, ASSISTANT DIRECTOR, PHYSICAL INFRASTRUCTURE ISSUES, GENERAL ACCOUNTING OFFICE; AND MICHAEL E. CLEMENTS, Ph.D., SENIOR ANALYST, PHYSICAL INFRASTRUCTURE ISSUES, GENERAL ACCOUNTING OFFICE

Mr. GOLDSTEIN. Thank you, Mr. Chairman. I'm accompanied today by Amy Abramowitz, the Assistant Director at the General Accounting Office, who conducted the study, and Michael Clements, the analyst in charge of the study.

The CHAIRMAN. Welcome to both of you. Thank you. Please proceed.

Mr. GOLDSTEIN. Thank you, Mr. Chairman and Members of the Committee. I'm pleased to be here today to report on our work on cable rates and competition of the cable television industry. In recent years, cable television has become a major component of the American entertainment industry, with more than 70 million households receiving television service from a cable operator.

While competition is emerging, especially from Direct Broadcast Satellite, or DBS, cable rates continue to increase at a faster pace than the general rate of inflation. As you know, in October 2003, we issued a report to you on these topics. We also issued a report to the Senate Judiciary Subcommittee on Antitrust on similar topics. My statement today will summarize the major findings from our October 2003 report with additional information from our February 2004 report.

First, wire-based competition is limited to very few markets. Cable subscribers in about 2 percent of all markets have the opportunity to choose between two or more wire-based competitors. However, in those markets where this competition is present, cable rates were about 15 percent lower than cable rates in similar markets without wire-based competition in 2001.

DBS operators have emerged as a nationwide competitors to cable operators, and this has been facilitated by the opportunity of DBS companies to provide local broadcast stations. Competition from DBS operators has induced cable operators to lower cable rates slightly, and DBS provision of local broadcast stations has induced cable operators to improve the quality of their service.

These findings from our 2003 report are based on a statistical model of over 700 cable franchises throughout the United States. For our February 2004 report, we further examined the impact of wire-based competition by looking at 12 markets, six with and six without wire-based competitions.

The findings are remarkably similar to our October 2003 report. Of the six markets with wire-based competition, cable rates are 15

to 41 percent higher—lower, excuse me—in five of the six markets compared to similar markets without wire-based competition.

Second, we found that a number of factors contributed to increase in cable rates. On the basis of data from nine cable operators, programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years. During the past 3 years, the cost of programming has increased at least 34 percent. During the same period, the cost of sports programming has increased 59 percent. Also, since 1996, the cable industry has spent over \$75 billion to upgrade its infrastructure. These two factors were the most commonly reported to us by industry participants as contributing to increasing cable rates.

Third, some industry representatives told us that the nature of ownership affiliations may indirectly influence cable rates. We did not find that ownership affiliations between cable networks and broadcasters, or between cable networks and cable operators, are associated with higher license fees.

However, we did find that both forms of ownership affiliation are associated with a greater likelihood that a cable operator would carry a cable network. In other words, cable networks owned by a broadcaster or cable operator were more likely to get carried on a cable system than independent cable networks.

Fourth, subscribers have little choice regarding the specific networks they receive with cable television service. Adopting an à la carte approach where subscribers could choose to pay for only those networks they desire would provide consumers with more individual choice, but it could require additional technology and could alter the current business model of the cable network industry, wherein cable networks obtain roughly half of their overall revenues from advertising.

A move to an à la carte approach could result in reduced advertising revenues and might result in higher per-channel rates and less diversity in program choice. We believe that a variety of factors, such as the pricing of à la carte service, consumers' purchasing patterns, and whether certain niche networks would cease to exist with à la carte service make it difficult to ascertain how many consumers would be better off and how many would be worse off under an à la carte approach.

Finally, some consumer groups have suggested that re-regulation of cable rates needs to be considered, since they believe it is the only alternative to mitigate increasing cable rates and the market power they believe that cable operators possess. However, others have noted problems with past efforts at regulating the cable industry.

Other options put forth include modifications to the program access rules, promoting additional wireless competition, and modifying the retransmission consent process. Any options designed to help bring down cable rates could have other unintended effects that would need to be considered in conjunction with the benefits of lower rates. We are not making any specific recommendations regarding the adoption of any of these options at this time.

Mr. Chairman, that concludes my prepared statement. I'd be happy to respond to any questions that you or other Members of the Committee may have at this time.

[The prepared statement of Mr. Goldstein follows:]

GAO HIGHLIGHTS

Telecommunications

Subscriber Rates and Competition in the Cable Television Industry

Why GAO Did This Study

In recent years, rates for cable service have increased at a faster pace than the general rate of inflation. GAO agreed to (1) examine the impact of competition on cable rates and service, (2) assess the reliability of information contained in the Federal Communications Commission's (FCC) annual cable rate report, (3) examine the causes of recent cable rate increases, (4) assess the impact of ownership affiliations in the cable industry, (5) discuss why cable operators group networks into tiers, and (6) discuss options to address factors that could be contributing to cable rate increases.

GAO issued its findings and recommendations in a report entitled *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry* (GAO-04-8). In that report, GAO recommended that the Chairman of FCC take steps to improve the reliability, consistency, and relevance of information on cable rates and competition in the subscription video industry. In commenting on GAO's report, FCC agreed to make changes to its annual cable rate survey, but FCC questioned, on a cost/benefit basis, the utility of revising its process to keep the classification of effective competition up to date. GAO believes that FCC should examine whether cost-effective alternative processes could help provide more accurate information. This testimony is based on that report.

What GAO Found

Competition leads to lower cable rates and improved quality. Competition from a wire-based company is limited to very few markets. However, where available, cable rates are substantially lower (by 15 percent) than in markets without this competition. Competition from direct broadcast satellite (DBS) companies is available nationwide, and the recent ability of these companies to provide local broadcast stations has enabled them to gain more customers. In markets where DBS companies provide local broadcast stations, cable operators improve the quality of their service.

FCC's cable rate report does not appear to provide a reliable source of information on the cost factors underlying cable rate increases or on the effects of competition. GAO found that cable operators did not complete FCC's survey in a consistent manner, primarily because the survey lacked clear guidance. Also, GAO found that FCC does not initiate updates or revisions to its classification of competitive and non-competitive areas. Thus, FCC's classifications might not reflect current conditions.

A variety of factors contribute to increasing cable rates. During the past 3 years, the cost of programming has increased considerably (at least 34 percent), driven by the high cost of original programming, among other things. Additionally, cable operators have invested large sums in upgraded infrastructures, which generally permit additional channels, digital service, and broadband Internet access.

Some concerns exist that ownership affiliations might indirectly influence cable rates. Broadcasters and cable operators own many cable networks. GAO found that cable networks affiliated with these companies are more likely to be carried by cable operators than nonaffiliated networks. However, cable networks affiliated with broadcasters or cable operators do not receive higher license fees, which are payments from cable operators to networks, than nonaffiliated networks.

Technological, economic, and contractual factors explain the practice of grouping networks into tiers, thereby limiting the flexibility that subscribers have to choose only the networks that they want to receive. An à la carte approach would facilitate more subscriber choice but require additional technology and customer service. Additionally, cable networks could lose advertising revenue. As a result, some subscribers' bills might decline but others might increase.

Certain options for addressing cable rates have been put forth. Although reregulation of cable rates is one option, promoting competition could influence cable rates through the market process. While industry participants have suggested several options for addressing increasing cable rates, these options could have other unintended effects that would need to be considered in conjunction with the benefits of lower rates.

PREPARED STATEMENT OF MARK L. GOLDSTEIN, DIRECTOR, PHYSICAL
INFRASTRUCTURE ISSUES, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Committee:

I am pleased to be here today to report on our work on cable rates and competition in the cable television industry. In recent years, cable television has become a major component of the American entertainment industry, with more than 70 million households receiving television service from a cable television operator. As the industry has developed, it has been affected by regulatory and economic changes. Since 1992, the industry has undergone rate reregulation and then in 1999, partial deregulation. Additionally, competition to cable operators has emerged erratically. Companies emerged in some areas to challenge cable operators, only to halt expansion or discontinue service altogether. Conversely, competition from direct broadcast satellite (DBS) operators has emerged and grown rapidly in recent years. Nevertheless, cable rates continue to increase at a faster pace than the general rate of inflation. As you know, on October 24, 2003, we issued a report to you on these issues, and issued a subsequent report to the Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights on similar issues.¹ My statement today will summarize the major findings from our October 2003 report, and additional findings from our February 2004 report.

At the request of this committee, we have (1) examined the impact of competition on cable rates and service; (2) assessed the reliability of the information contained in the Federal Communications Commission's (FCC) annual cable rate report on the cost factors underlying cable rate increases, FCC's current classification of cable franchises regarding whether they face effective competition, and FCC's related findings on the effect of competition; (3) examined the causes of recent cable rate increases; (4) assessed whether ownership of cable networks (such as CNN and ESPN) may indirectly affect cable rates through such ownership's influence on cable network license fees or the carriage of cable networks; (5) discussed why cable operators group networks into tiers, rather than package networks so that customers can purchase only those networks they wish to receive; and (6) discussed options to address factors that could be contributing to cable rate increases.

To address these issues, we developed an empirical model (our cable-satellite model) that examined the effect of competition on cable rates and service using data from 2001;² conducted a telephone survey with 100 randomly sampled cable franchises that responded to FCC's 2002 cable rate survey, and asked these franchises a series of questions about how they completed a portion of FCC's survey that addresses cost factors underlying annual cable rate changes; interviewed representatives of the cable operator, cable network, and broadcast industries; and developed empirical models that examined whether ownership of cable networks by broadcasters or by cable operators influenced (1) the level of license fee (our cable license fee model) or (2) the likelihood that the network will be carried (our cable network carriage model) based on data from 2002. For a more detailed description of our scope and methodology, see appendix I.

This testimony is based on our report issued October 24, 2003, for which we did our work from December 2002 through September 2003. We provide additional information based on our report issued February 2, 2004, for which we did our work from May 2003 to December 2003. We performed our work for both assignments in accordance with generally accepted government auditing standards.

My statement will make the following points:

- Wire-based competition is limited to very few markets; according to FCC, cable subscribers in about 2 percent of all markets have the opportunity to choose between two or more wire-based operators. However, in those markets where this competition is present, cable rates are about 15 percent lower than cable rates in similar markets without wire-based competition in 2001. In our February 2004 report, we examined 6 markets with wire-based competition in depth and found that cable rates in 5 of these 6 markets were 15 to 41 percent lower than similar markets without wire-based competition in 2003. DBS operators have emerged as a nationwide competitor to cable operators, which has been facilitated by the opportunity to provide local broadcast stations. Competition from

¹See U.S. General Accounting Office, *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (Washington, D.C.: Oct. 24, 2003) and U.S. General Accounting Office, *Telecommunications: Wire-Based Competition Benefited Consumers in Selected Markets*, GAO-04-241 (Washington, D.C.: Feb. 2, 2004).

²Our model was based on data from 2001 since this was the most recent year for which we were able to acquire the required data on cable rates and services and DBS penetration rates when we began our analysis.

DBS operators has induced cable operators to lower cable rates slightly, and DBS provision of local broadcast stations has induced cable operators to improve the quality of their service.

- As we mentioned in our May 6, 2003, testimony before this Committee, certain issues undermine the reliability of information in FCC's cable rate report, which provides information on cable rates and competition in the subscription video industry.³ Because the Congress and FCC use this information in their monitoring and oversight of the cable industry, the lack of reliable information in FCC's cable rate report may compromise the ability of the Congress and FCC to fulfill these roles. To improve the quality and usefulness of the data FCC collects annually, we recommend that the Chairman of FCC take steps to improve the reliability, consistency, and relevance of information on rates and competition in the subscription video industry.
- We found that a number of factors contributed to the increase in cable rates. On the basis of data from 9 cable operators, programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years. During the past 3 years, the cost of programming has increased at least 34 percent. Also, since 1996, the cable industry has spent over \$75 billion to upgrade its infrastructure.
- Some industry representatives believe that certain factors related to the nature of ownership affiliations may also indirectly influence cable rates. We did not find that ownership affiliations between cable networks (such as CNN and ESPN) and broadcasters (such as NBC and CBS) or between cable networks and cable operators (such as Time Warner and Cablevision) are associated with higher license fees—that is, the fees cable operators pay to carry cable networks. However, we did find that both forms of ownership affiliations are associated with a greater likelihood that a cable operator would carry a cable network.
- Today, subscribers have little choice regarding the specific networks they receive with cable television service. Adopting an à la carte approach, where subscribers could choose to pay for only those networks they desire, would provide consumers with more individual choice, but could require additional technology and could alter the current business model of the cable network industry wherein cable networks obtain roughly half of their overall revenues from advertising. A move to an à la carte approach could result in reduced advertising revenues and might result in higher per-channel rates and less diversity in program choice. A variety of factors—such as the pricing of à la carte service, consumers' purchasing patterns, and whether certain niche networks would cease to exist with à la carte service—make it difficult to ascertain how many consumers would be better off and how many would be worse off under an à la carte approach.
- Certain options for addressing factors that may be contributing to cable rate increases have been put forth. Some consumer groups have suggested that reregulation of cable rates needs to be considered, although others have noted problems with past efforts at regulation. Other options put forth include reviewing whether modifications to the program access rules would be beneficial, promoting wireless competition, and reviewing whether changes to the retransmission consent process should be considered. Any options designed to help bring down cable rates could have other unintended effects that would need to be considered in conjunction with the benefits of lower rates. We are not making any specific recommendations regarding the adoption of these options.

Background

Cable television emerged in the late 1940s to fill a need for television service in areas with poor over-the-air reception, such as mountainous or remote areas. By the late 1970s, cable operators began to compete more directly with free over-the-air television by providing new cable networks, such as HBO, Showtime, and ESPN. According to FCC, cable's penetration rate—as a percentage of television households—increased from 14 percent in 1975 to 24 percent in 1980 and to 67 percent today. Cable television is by far the largest segment of the subscription video market, a market that includes cable television, satellite service (including DBS operators such as DIRECTV and EchoStar), and other technologies that deliver video services to customers' homes.

³See U.S. General Accounting Office, *Telecommunications: Data Gathering Weaknesses In FCC's Survey Of Information On Factors Underlying Cable Rate Changes*, GAO-03-742T (Washington, D.C.: May 6, 2003).

To provide programming to their subscribers, cable operators (1) acquire the rights to carry cable networks from a variety of sources and (2) pay license fees—usually on a per-subscriber basis—for these rights. The three primary types of owners of cable networks are large media companies that also own major broadcast networks (such as Disney and Viacom), large cable operators (such as Time Warner and Cablevision), and independent programmers (such as Landmark Communications).

At the community level, cable operators obtain a franchise license under agreed-upon terms and conditions from a franchising authority, such as a local or state government. During cable's early years, franchising authorities regulated many aspects of cable television service, including subscriber rates. In 1984, the Congress passed the Cable Communications Policy Act, which imposed some limitations on franchising authorities' regulation of rates.⁴ However, 8 years later in response to increasing rates, the Congress passed the Cable Television Consumer Protection and Competition Act of 1992. The 1992 Act required FCC to establish regulations ensuring reasonable rates for basic service—the lowest level of cable service, which includes the local broadcast stations—unless a cable system has been found to be subject to effective competition, which the act defined.⁵ The act also gave FCC the authority to regulate any unreasonable rates for upper tiers (often referred to as expanded-basic service), which include cable programming provided over and above that provided on the basic tier.⁶ Expanded-basic service typically includes such popular cable networks as USA Network, ESPN, and CNN. In anticipation of growing competition from satellite and wire-based operators, the Telecommunications Act of 1996 phased out all regulation of expanded-basic service rates by March 31, 1999. However, franchising authorities can regulate the basic tier of cable service where there is no effective competition.

As required by the 1992 Act, FCC annually reports on average cable rates for operators found to be subject to effective competition compared with operators not subject to effective competition. To fulfill this mandate, FCC annually surveys a sample of cable franchises regarding their cable rates. In addition to asking questions that are necessary to gather information to provide its mandated reports, FCC also typically asks questions to help the agency better understand the cable industry. For example, the 2002 survey included questions about a range of cable issues, including the cost factors underlying changes in cable rates, the percentage of subscribers purchasing other services (such as broadband Internet access and telephone service), and the specifics of the programming channels offered on each tier.

Some franchise agreements were initially established on an exclusive basis, thereby preventing wire-based competition to the initial cable operator. In 1992, the Congress prohibited the awarding of exclusive franchises, and, in 1996, the Congress took steps to allow telephone companies and electric companies to enter the video market. Initially unveiled in 1994, DBS served about 18 million American households by June 2002. Today, two of the five largest subscription video service providers are DIRECTV and EchoStar—the two primary DBS operators.

Competition Leads to Lower Cable Rates and Improved Quality and Service among Cable Operators

Competition from a wire-based provider—that is, a competitor using a wire technology—is limited to very few markets, but where available, has a downward impact on cable rates. In a recent report, FCC noted that very few markets—about 2 percent—have been found to have effective competition based on the presence of a wire-based competitor.⁷ Our interviews with cable operators and financial analysis firms yielded a similar finding—wire-based competition is limited. However, according to our cable-satellite model that included over 700 cable franchises throughout the United States in 2001, cable rates were approximately 15 percent lower in areas where a wire-based competitor was present. With an average monthly cable rate of approximately \$34 that year, this implies that subscribers in areas with a wire-based competitor had monthly cable rates about \$5 lower, on average, than subscribers in similar areas without a wire-based competitor. Our interviews with cable

⁴Under the 1984 Act and FCC's subsequent rulemaking, over 90 percent of all cable systems were not subject to rate regulation.

⁵Under statutory definitions in the 1992 Act, substantially more cable operators were subject to rate regulations than had previously been the case.

⁶Basic and expanded-basic are the most commonly subscribed to service tiers—bundles of networks grouped into a package—offered by cable operators. In addition, customers in many areas can purchase digital tiers and also premium pay channels, such as HBO and Showtime.

⁷See Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, Ninth Annual Report*, FCC 02-338 (Washington, D.C.: Dec. 31, 2002).

operators also revealed that these companies generally lower rates and/or improve customer service where a wire-based competitor is present.

For our February 2004 report to the Senate Judiciary Subcommittee on Antitrust, Competition Policy and Consumer Rights, we developed an alternative methodology to examine the relationship between cable rates and wire-based competition. In particular, we developed a case-study approach that compared 6 cities where a broadband service provider (BSP)—new wire-based competitors that generally offer local telephone, subscription television, and high-speed Internet services to consumers—has been operating for at least 1 year with 6 similar cities that do not have such a competitor. We compared the *lowest price available* for cable service in the market with a BSP to the price for cable service offered in markets without a BSP.

We found that cable rates were generally lower in the 6 markets we examined with a BSP present than in the 6 markets that did not have BSP competition. However, the extent to which rates were lower in a BSP market compared to its “matched market” varied considerably across markets. For example, in 1 BSP market, the monthly rate for cable television service was 41 percent lower compared with the matched market, and in 2 other BSP locations, cable rates were more than 30 percent lower when compared with their matched markets. In two other BSP markets, rates were lower by 15 and 17 percent, respectively, in the BSP market compared to its matched market. On the other hand, in 1 of the BSP markets, the price for cable television service was 3 percent *higher* in the BSP market than it was in the matched market.

In recent years, DBS has become the primary competitor to cable operators. The ability of DBS operators to compete against cable operators was bolstered in 1999 when they acquired the legal right to provide local broadcast stations—such as over-the-air affiliates of ABC, CBS, Fox, and NBC—via satellite to their customers.⁸ On the basis of our cable-satellite model, we found that in areas where subscribers can receive local broadcast stations from both primary DBS operators, the DBS penetration rate is approximately 40 percent higher than in areas where subscribers cannot receive these stations from the DBS operators. In terms of rates, we found that a 10 percent higher DBS penetration rate in a franchise area is associated with a slight rate reduction—about 15 cents per month. Also, in areas where both primary DBS operators provide local broadcast stations, we found that the cable operators offer subscribers approximately 5 percent more cable networks than cable operators in areas where this is not the case. During our interviews with cable operators, most operators told us that they responded to DBS competition through one or more of the following strategies: focusing on customer service, providing bundles of services to subscribers, and lowering prices and providing discounts.

Concerns Exist about the Reliability of FCC’s Data for Cable Operator Cost Factors and Effective Competition

As we mentioned in our May 6, 2003, testimony before this Committee, weaknesses in FCC’s survey of cable franchises may lead to inaccuracies in the relative importance of cost factors reported by FCC. Cable franchises responding to FCC’s 2002 survey did not complete in a consistent manner the section pertaining to the factors underlying cable rate increases primarily because of a lack of clear guidance. These inconsistencies may have led to unreliable information in FCC’s report on the relative importance of factors underlying recent cable rate increases. Overall, we found that 84 of the 100 franchises we surveyed did not provide a complete or accurate accounting of their cost changes for the year. As such, an overall accurate picture of the relative importance of various cost factors, which may be important for FCC and congressional oversight, may not be reflected in FCC’s data.

FCC’s cable rate report also does not appear to provide a reliable source of information on the effect of competition. FCC is required by statute to produce an annual report on the differences between average cable rates in areas that FCC has found to have effective competition compared with those that have not had such a finding. However, FCC’s process for implementing this mandate may lead to situations in which the effective competition designation may not reflect the actual state of competition in the current time frame. In particular, FCC relies exclusively on external parties to file for changes in the designation. Using data from FCC’s 2002 survey, we conducted several tests to determine whether information contained in fran-

⁸In 1999, the Congress passed the Satellite Home Viewer Improvement Act, which allows satellite operators to provide local broadcast stations to their customers. Prior to this act, satellite operators were limited to providing local broadcast stations to *unserved areas* where customers could not receive sufficiently high-quality, over-the-air signals. This practice had the general effect of preventing satellite operators from providing local broadcast stations directly to customers in most circumstances.

chises' survey information—which was filed with FCC in mid-2002—was consistent with the designation of effective competition for the franchise in FCC's records. We found some discrepancies. These discrepancies may explain, in part, the differential findings regarding the impact of wire-based competition reported by FCC, which found a nearly 7 percent reduction in cable rates, and our finding of a 15 percent reduction in cable rates.

Because the Congress and FCC use this information in their monitoring and oversight of the cable industry, the lack of reliable information in FCC's report on these two issues—factors underlying cable rate increases and the effect of competition—may compromise the ability of the Congress and FCC to fulfill these roles. Additionally, the potential for this information to be used in debate regarding important policy decisions, such as media consolidation, also necessitates reliable information in FCC's report. As a result, we recommended that the Chairman of FCC improve the reliability, consistency, and relevance of information on cable rates and competition in the subscription video industry by (1) taking immediate steps to improve its cable rate survey and (2) reviewing the commission's process for maintaining the classification of effective competition.⁹ In commenting on our report, FCC agreed to make changes to its annual cable rate survey in an attempt to obtain more accurate information, but questioned, on a cost/benefit basis, the utility of revising its process to keep the classification of effective competition in franchises up to date. We recognize that there are costs associated with FCC's cable rate survey, and we recommend that FCC examine whether cost-effective alternative processes exist that would enhance the accuracy of its effective competition designations.

A Variety of Factors Contribute to Cable Rate Increases

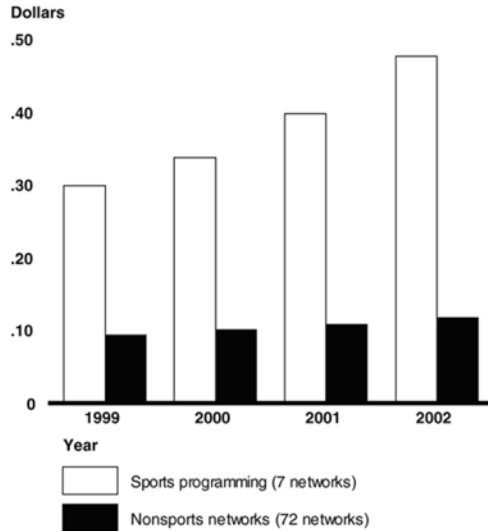
Increases in expenditures on cable programming contribute to higher cable rates. A majority of cable operators and cable networks, and all financial analysts that we interviewed told us that high programming costs contributed to rising cable rates. On the basis of financial data supplied to us by 9 cable operators, we found that these operators' yearly programming expenses, on a per-subscriber basis, increased from \$122 in 1999 to \$180 in 2002—a 48 percent increase.¹⁰ Almost all of the cable operators we interviewed cited sports programming as a major contributor to higher programming costs. On the basis of our analysis of Kagan World Media data, the average license fees for a cable network that shows almost exclusively sports-related programming increased by 59 percent, compared to approximately 26 percent for 72 nonsports networks, in the 3 years between 1999 and 2002.¹¹ Further, the average license fees for the sports networks were substantially higher than the average for the nonsports networks (see fig. 1).

⁹See U.S. General Accounting Office, *Telecommunications: Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8 (Washington, D.C.: Oct. 24, 2003), page 45 for a full discussion of our recommendations.

¹⁰Using data from Kagan World Media, we found that the average fees cable operators must pay to purchase programming (referred to as license fees) increased by 34 percent from 1999 to 2002.

¹¹The seven national sports networks that we included in our analysis were ESPN, ESPN Classic, ESPN2, FOX Sports Net, The Golf Channel, The Outdoor Channel, and the Speed Channel.

Figure 1: Average Monthly License Fees per Subscriber—Sports Networks v. Nonsports Networks, 1999-2002



Source: GAO analysis of Kagan World Media data.

The cable network executives we interviewed cited several reasons for increasing programming costs. We were told that competition among networks to produce and show content that will attract viewers has become more intense. This competition, we were told, has bid up the cost of key inputs (such as talented writers and producers) and has sparked more investment in programming. Most notably, these executives told us that networks today are increasing the amount of original content and improving the quality of programming generally.

Although programming is a major expense for cable operators, several cable network executives we interviewed also pointed out that cable operators offset some of the cost of programming through advertising revenues. Local advertising dollars account for about 7 percent of the total revenues in the 1999 to 2002 time frame for the 9 cable operators that supplied us with financial data. For these 9 cable operators, gross local advertising revenues—before adjusting for the cost of inserting and selling advertising—amounted to about \$55 per subscriber in 2002 and offset approximately 31 percent of their total programming expenses.¹²

In addition to higher programming costs, the cable industry has spent over \$75 billion between 1996 and 2002 to upgrade its infrastructure by replacing degraded coaxial cable with fiber optics and adding digital capabilities. As a result of these expenditures, FCC reported that there have been increases in channel capacity; the deployment of digital transmissions; and nonvideo services, such as Internet access and telephone service.¹³ Many cable operators, cable networks, and financial analysts we interviewed said investments in system upgrades contributed to increases in consumer cable rates.

Programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years. On the basis of financial data from 9 cable operators, we found that annual subscriber video-based revenues increased approximately \$79 per subscriber from 1999 to 2002. During this same period, programming expenses increased approximately \$57 per subscriber. Depreciation expenses on cable-based property, plant, and equipment—an indicator of expenses related to infrastructure investment—increased approximately \$80 per subscriber during the same period. However, because these infrastructure-related ex-

¹² Advertising sales revenues net of expenses incurred to insert and sell local advertising would offset a lower percentage of cable operators' programming expenses.

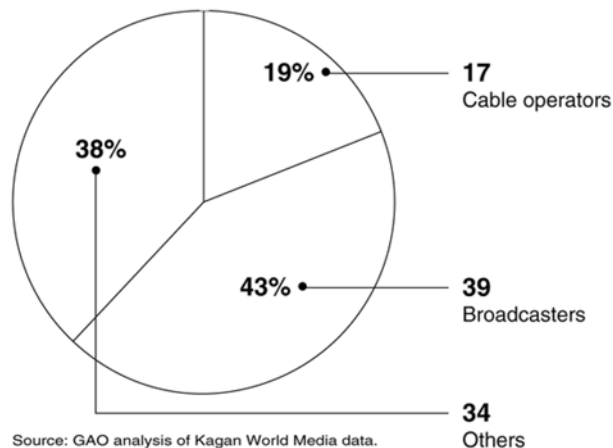
¹³ For example, FCC reported that approximately 74 percent of cable systems had system capacity of at least 750 MHz, and that approximately 70 percent of cable subscribers were offered high-speed Internet access by their cable operator in 2002.

penses are associated with more than one service, it is unclear how much of this cost should be attributed to video-based services. Moreover, cable operators are enjoying increased revenues from nonvideo sources. For example, revenues from Internet-based services increased approximately \$74 per subscriber during the same period.

Some View Ownership Affiliations as an Important Indirect Influence on Cable Rates

Several industry representatives and experts we interviewed told us that they believe ownership affiliation may also influence the cost of programming and thus, indirectly, the rates for cable service. Of the 90 cable networks that are carried most frequently on cable operators' basic or expanded-basic tiers, we found that approximately 19 percent were majority-owned (*i.e.*, at least 50 percent owned) by a cable operator, approximately 43 percent were majority-owned by a broadcaster, and the remaining 38 percent of the networks are not majority-owned by broadcasters or cable operators (see fig. 2).

Figure 2: Ownership Affiliation of the 90 Most Carried Cable Networks



Source: GAO analysis of Kagan World Media data.

Note: Cable networks were assumed affiliated if the ownership interest was 50 percent or greater.

Despite the view held by some industry representatives with whom we spoke that license fees for cable networks owned by either cable operators or broadcasters tend to be higher than fees for other cable networks, we did not find this to be the case. We found that cable networks that have an ownership affiliation with a broadcaster did not have, on average, higher license fees (*i.e.*, the fee the cable operator pays to the cable network) than cable networks that were not majority-owned by broadcasters or cable operators. We did find that license fees were statistically higher for cable networks owned by cable operators than was the case for cable networks that were not majority-owned by broadcasters or cable operators. However, when using a regression analysis (our cable license fee model) to hold constant other factors that could influence the level of the license fee, we found that ownership affiliations—with broadcasters or with cable operators—had no influence on cable networks' license fees.¹⁴ We did find that networks with higher advertising revenues per subscriber (a proxy for popularity) and sports networks received higher license fees.

Industry representatives we interviewed also told us that cable networks owned by cable operators or broadcasters are more likely to be carried by cable operators than other cable networks. On the basis of our cable network carriage model—a model designed to examine the likelihood of a cable network being carried—we found that cable networks affiliated with broadcasters or with cable operators are more likely to be carried than other cable networks. In particular, we found that networks owned by a broadcaster or by a cable operator were 46 percent and 31 per-

¹⁴In the cable license fee model, we regressed the average monthly license fee for 90 cable networks on a series of variables that might influence the license fee. See GAO-04-8 for a list of variables included in that model.

cent, respectively, more likely to be carried than a network without majority ownership by either of these types of companies. Additionally, we found that cable operators were much more likely to carry networks that they themselves own. A cable operator is 64 percent more likely to carry a cable network it owns than to carry a network with any other ownership affiliation.

Several Factors Generally Lead Cable Operators to Offer Large Tiers of Networks Instead of Providing A La Carte or Minitier Service

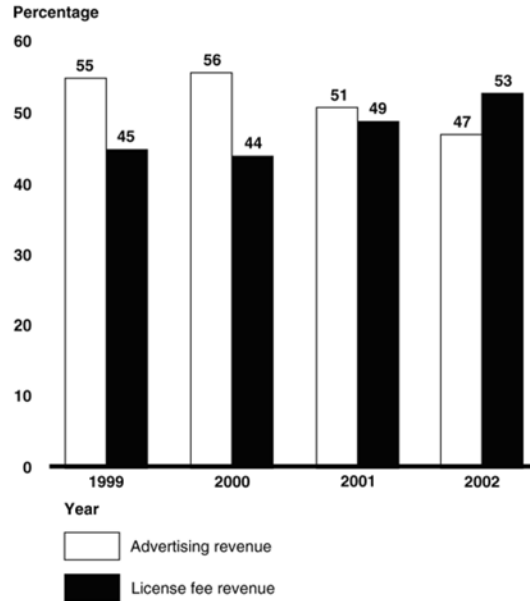
Using data from FCC's 2002 cable rate survey, we found that with basic tier service, subscribers receive, on average, approximately 25 channels, which include the local broadcast stations. The expanded-basic tier provides, on average, an additional 36 channels. In general, to have access to the most widely distributed cable networks—such as ESPN, TNT, and CNN—most subscribers must purchase the expanded-basic tier of service. Because subscribers must buy all of the networks offered on a tier that they choose to purchase, they have little choice regarding the individual networks they receive.

If cable operators were to offer all networks on an à la carte basis—that is, if consumers could select the individual networks they wish to purchase—additional technology upgrades would be necessary in the near term. In particular, subscribers would need to have an addressable converter box on every television set attached to the cable system to unscramble the signals of the networks that the subscriber has agreed to purchase.

According to FCC's 2002 survey data, the average monthly rental price for an addressable converter box is approximately \$4.39. Although cable operators have been placing addressable converter boxes in the homes of customers who subscribe to scrambled networks, many homes do not currently have addressable converter boxes or do not have them on all of the television sets attached to the cable system. Since cable operators may move toward having a greater portion of their networks provided on a digital tier in the future, these boxes will need to be deployed in greater numbers, although it is unclear of the time frame over which this will occur. Also, consumer electronic manufactures have recently submitted plans to FCC regarding specifications for new television sets that will effectively have the functionality of an addressable converter box within the television set. Once most customers have addressable converter boxes or these new televisions in place, the technical difficulties of an à la carte approach would be mitigated.

If cable subscribers were allowed to choose networks on an à la carte basis, the economics of the cable network industry could be altered. If this were to occur, it is possible that cable rates could actually increase for some consumers. In particular, we found that cable networks earn much of their revenue from the sale of advertising that airs during their programming. Our analysis of information on 79 networks from Kagan World Media indicates that these cable networks received nearly half of their revenue from advertising in 2002; the majority of the remaining revenue is derived from the license fees that cable operators pay networks for the right to carry their signal (see fig. 3).

Figure 3: Percentage of Cable Network Advertising Revenue Compared with License Fee Revenues for 79 Cable Networks, 1999 – 2002



Source: GAO analysis of Kagan World Media data.

Note: Although cable networks have other sources of revenues, advertising and license fee revenues comprise the vast majority of cable network revenues.

To receive the maximum revenue possible from advertisers, cable networks strive to be on cable operators' most widely distributed tiers because advertisers will pay more to place an advertisement on a network that will be viewed, or have the potential to be viewed, by the greatest number of people.¹⁵ According to cable network representatives we interviewed, any movement of networks from the most widely distributed tiers to an à la carte format could result in a reduced amount that advertisers are willing to pay for advertising time. To compensate for any decline in advertising revenue, network representatives contend that cable networks would likely increase the license fees they charge to cable operators. Because increased license fees, to the extent that they occur, are likely to be passed on to subscribers, it appears that subscribers' monthly cable bills would not necessarily decline under an à la carte system. Moreover, most cable networks we interviewed also believe that programming diversity would suffer under an à la carte system because some cable networks, especially small and independent networks, would not be able to gain enough subscribers to support the network.

The manner in which an à la carte approach might impact advertising revenues, and ultimately the cost of cable service, rests on assumptions regarding customer choice and pricing mechanisms. In particular, the cable operators and cable networks that discussed these issues with us appeared to assume that many customers, if faced with an à la carte selection of networks, would choose to receive only a limited number of networks, which is consistent with the data on viewing habits. In fact, some industry representatives had different views on the degree to which consumers place value on networks they do not typically watch. While two experts suggested that it is not clear whether more networks are a benefit to subscribers, others noted that subscribers place value in having the opportunity to occasionally watch networks they typically do not watch. Additionally, the number of cable net-

¹⁵ Most contracts negotiated between cable networks and cable operators specify the tier that the network must appear on. We were told that cable networks include these provisions in their contracts because their business models are developed on the basis of a wide distribution of their network.

works that customers choose to purchase will also be influenced by the manner in which cable operators price services under an à la carte scenario. Thus, there are a variety of factors that make it difficult to ascertain how many consumers would be made better off and how many would be made worse off under an à la carte approach. These factors include how cable operators would price their services under an à la carte system; the distribution of consumers' purchasing patterns; whether niche networks would cease to exist, and, if so, how many would exit the industry; and consumers' true valuation of networks they typically do not watch.

Industry Participants Have Cited Certain Options That May Address Factors Contributing to Rising Cable Rates

Industry participants have suggested the following options for addressing the cable rate issue. This discussion is an overview, and we are not making any specific recommendations regarding the adoption of any of these options.

- Some consumer groups have pointed to the lack of competition as evidence that reregulation needs to be considered because it might be the only alternative to mitigate increasing cable rates and cable operators' market power. However, some experts expressed concerns about cable regulation after the 1992 Act, including lowering of the quality of programming, discouragement of investment in new facilities, and imposition of administrative burdens on the industry and regulators.
- The 1992 Act included provisions to ensure that cable networks that have ownership relationships with cable operators (*i.e.*, vertically integrated cable operators) generally make their satellite-delivered programming available to competitors. Some have expressed concern that the law is too narrow because it applies only to *the satellite-delivered programming* of vertically integrated cable operators and it does not prohibit exclusive contracts between a cable operator and an independent cable network. Given these concerns, some have suggested that changes in the statutory program access provisions might enhance the ability of other providers to compete with the incumbent cable operators while others have noted that altering these provisions could reduce the incentive for companies to develop innovative programming.
- DBS operators have stated that they are currently not able to provide local broadcast stations in all 210 television markets in the United States because they do not have adequate spectrum to do so while still providing a wide variety of national networks. As part of the so-called carry one, carry all provisions, these companies are required to provide all local broadcast stations in markets where they provide any of those stations. Some suggest modifying the *carry one, carry all* provisions to promote carriage of local stations in more markets. However, any modifications to the DBS carry one, carry all rules would need to be examined in the context of why those rules were put into place—that is, to ensure that all broadcast stations are available in markets where DBS providers choose to provide local stations.
- In the 1992 Act, the Congress created a mechanism, known as retransmission consent, through which local broadcast station owners (such as local ABC, CBS, Fox, and NBC affiliates) could receive compensation from cable operators in return for the right to carry their broadcast stations. Today, few retransmission consent agreements include cash payment for carriage of the local broadcast station. Rather, agreements between some large broadcast groups and cable operators generally include provisions for carriage of broadcaster-owned cable networks. As a result, cable operators sometimes carry cable networks they otherwise might not have carried. Alternatively, representatives of the broadcast networks told us that they did not believe that cable networks had been dropped and that they accept cash payment for carriage of the broadcast signal, but that cable operators tend to prefer carriage options in lieu of a cash payment. Certain industry participants with whom we met advocated the removal of the retransmission consent provisions and told us that this may have the effect of lowering cable rates, but others have stated that such provisions serve to enable television stations to obtain a fair return for the retransmitted content they provide and that retransmission rules help to ensure the continued availability of free television for all Americans.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

APPENDIX I: SCOPE AND METHODOLOGY

To respond to the first issue—examine the impact of competition on cable rates—we used an empirical model (our cable-satellite model) that we previously developed that examines the effect of competition on cable rates and services.¹ Using data from the Federal Communications Commission’s (FCC) 2001 cable rate survey, the model considers the effect of various factors on cable rates, the number of cable subscribers, the number of channels that cable operators provide to subscribers, and direct broadcast satellite (DBS) penetration rates for areas throughout the United States. We further developed the model to more explicitly examine whether varied forms of competition—such as wire-based, DBS, multipoint multichannel distribution systems (MMDS) competition—have differential effects on cable rates. In addition, we spoke with an array of industry stakeholders and experts (see below) to gain further insights on these issues.

The second issue consists of two parts. To respond to part one—assess the reliability of the cost justifications for rate increases provided by cable operators to FCC, we conducted a telephone survey (our cable franchise survey), from January 2003 through March 2003, of cable franchises that responded to FCC’s 2002 cable rate survey. We drew a random sample of 100 of these cable franchises; the sample design was intended to be representative of the 755 cable franchises that responded to FCC’s survey. We used data from FCC, and conversations with company officials, to determine the most appropriate staff person at the franchise to complete our survey. To ensure that our survey gathered information that addressed this objective, we conducted telephone pretests with several cable franchises and made the appropriate changes on the basis of the pretests. We asked cable franchises a series of open-ended questions regarding how the franchise staff calculated cost and noncost factors on FCC’s 2002 cable rate survey, how well the franchise staff understood what FCC wanted for those factors, and franchise staff’s suggestions for improving FCC’s cable rate survey. All 100 franchises participated in our survey, for a 100 percent response rate. In conducting this survey, we did not independently verify the answers that the franchises provided to us.

Additionally, to address part two of the second issue—assess FCC’s classifications of effective competition—we examined FCC’s classification of cable franchises regarding whether they face effective competition.

Using responses to FCC’s 2002 cable rate survey, we tested whether the responses provided by cable franchises were consistent with the various legal definitions of effective competition, such as the low-penetration test. Further, we reviewed documents from FCC proceedings addressing effective competition filings and contacted franchises to determine whether the conditions present at the time of the filing remain in effect today.

To address the third, fourth, fifth, and sixth issues (examine reasons for recent rate increases, examine whether ownership relationships between cable networks and cable operators and/or broadcasters influence the level of license fees for the cable networks or the likelihood that a cable network will be carried, examine why cable operators group networks into tiers rather than sell networks individually, and discuss options to address factors that could be contributing to cable rate increases), we took several steps, as follows:

- We conducted semistructured interviews with a variety of industry participants. We interviewed officials and obtained documents from FCC and the Bureau of Labor Statistics. We interviewed 15 cable networks—12 national and 3 regional—from a listing published by the National Cable and Telecommunications Association (NCTA), striving for a mixture of networks that have a large and small number of subscribers and that provide varying content, such as entertainment, sports, music, and news. We interviewed 11 cable operators, which included the 10 largest publicly traded cable operators and 1 medium-sized, privately held cable operator. In addition, we interviewed the four largest broadcast networks, one DBS operator, representatives from three major professional sports leagues, and five financial analysts that cover the cable industry. Finally, we interviewed officials from NCTA, Consumers Union, the National Association of Broadcasters, the National Association of Telecommunications Officers and Advisors, the American Cable Association, the National Cable Television Cooperative, and the Cable Television Advertising Bureau.
- We solicited the 11 cable operators we interviewed to gather financial and operating data and reviewed relevant Securities and Exchange Commission filings

¹ See U.S. General Accounting Office, *Telecommunications: Issues in Providing Cable and Satellite Television Services*, GAO-03-130 (Washington, D.C.: Oct. 15, 2002).

for these operators. Nine of the 11 cable operators provided the financial and operating data we sought for the period 1999 to 2002. We also acquired data from Kagan World Media, which is a private communications research firm that specializes in the cable industry. These data provided us with revenue and programming expenses for over 75 cable networks.

- We compared the average license fees among three groups of networks: those that are majority-owned by a broadcaster, those that are majority-owned by a cable operator, and all others. We performed t-tests on the significance of these differences. We also ran a regression (our cable license fee model) in which we regressed the license fee across 90 cable networks on the age of the network, the advertising revenues per subscriber (a measure of network popularity), dummy variables for sports and news programming, and a variety of factors about each franchise.
- We conducted several empirical tests on the channel lineups of cable operators as reported to FCC in its 2002 cable rate survey. We developed an empirical model (our cable network carriage model) that examined the factors that influence the probability of a cable network being carried on a cable franchise, including factors such as ownership affiliations and the popularity of the network. Further, we developed descriptive statistics on the characteristics of various tiers of service and the channels included in the various tiers.

The CHAIRMAN. Thank you very much. Why do satellite service providers have such a poor competitive effect on incumbent cable operators' rates?

Mr. GOLDSTEIN. Mr. Chairman, they do have some effect and we believe that that effect is actually growing. The data that we used was the latest available to create our model, which is 2001. Our sense is that that has—is changing and has changed since then. Ms. Abramowitz may actually be able to offer some more insight from that model actually.

Ms. ABRAMOWITZ. Yes, I think that one of the interesting things that we found when we first looked at the effect of the DBS industry on cable rates that was back in a report that we did in the year 1999, and we actually found an inverse effect, that is, where DBS was more penetrated. Cable rates were actually higher, which is not what you'd expect based on the economics.

When we looked at it again based on 2001 data, it had turned around, albeit a very slight pricing effect, but we think that that does reflect that it is becoming a much more competitive service, more people in major cities see it as a competitive service because they can get the local channels. And we think as you look at this over time it's likely that, in addition to the effect it's had on the quality of cable by inducing more infrastructure investments and more channels, it may also have a bigger price effect in the future.

The CHAIRMAN. On the issue of à la carte, Mr. Goldstein, I was a little disappointed in that you post it as an either/or kind of situation. What some of us are advocating is allowing people to buy a package or buy à la carte. That renders moot this argument as to who would have to pay more under what circumstances. In other words, if I'm a consumer and I only want to buy one channel, maybe I should be able to, maybe I want to as I—as you can when you go to the market you can buy one basket of a lot of different items or you can buy those items separately.

So, and by the way, this analogy of when I buy a newspaper and I don't have to—I have to purchase the business section and the sports section, what about when you go to the store and you buy a news magazine, you don't have to buy *Sports Illustrated* and *Auto Mechanics* along with it? That seems to me that's a little more of

an analogy than saying you're not going to buy parts of a newspaper. You pick up a news magazine, there's business, there are sports, et cetera, but I don't have to buy *Sports Illustrated* and I don't have to buy *Business Week* and I don't have to buy *Motor Trend* and I don't have to buy all of these others.

So, you know, I mean, it's ridiculous to make the kind of comparison frankly that's being made. But why—what's wrong, Mr. Goldstein, of providing the consumer with the opportunity of buying a tier and a package or buying separately? What's your problem with that?

Mr. GOLDSTEIN. Mr. Chairman, we actually think that an à la carte approach would facilitate greater choice for consumer. What we were simply doing is raising some of the issues we believe are out there that need to be considered. There are still millions of homes that would not have access because they don't have addressable set-top boxes and virtually everyone we talked to in our study told us that for contracting and business model-type reasons, whether it was the industry, the financial analysts, or advertising, that it would be very difficult to understand who might be better off and who would be worse off.

The CHAIRMAN. Do your experts have anything to add to that?

Ms. ABRAMOWITZ. I guess the only thing that I would add is that, in the context of is it an either/or, if you offered that choice that people could take individual channels, you basically would need to scramble all of the channels. Otherwise people would be able to get everything whether they paid for it or not, and that's wherein the technology issues comes into play.

The CHAIRMAN. But isn't that where digital is making this problem a lot less?

Ms. ABRAMOWITZ. Absolutely. With time that issue will go away.

Mr. GOLDSTEIN. It's unclear at this point how long it will take. Some say it's just a couple years, some say it is longer.

The CHAIRMAN. Well, obviously nobody's interested in setting cable rates. That experiment has been tried. Obviously the status quo, when you have inflation three times the rate of inflation at least, cable rates going up, and you have increasing concentration where the programmers are also the broadcasters who are also the network owners who also own the cable that it makes it very easy to just pass those costs right on down the line.

It seems to me we have a problem here, Mr. Goldstein, and that is that are we going to have cable be affordable as more and more Americans go to either cable or DBS. Are they going to be able to afford it? I would argue that probably the bulk of the over-the-air television today is watched by lower income Americans, and to say that I have to, I'm going to force that low income American to pay a very large amount of money for channels that he or she or their family will never watch, will never watch, it seems to me unfair.

So if someone wants to buy a package, let them buy a package, but also let them buy a single cable. And to the announcement that they're going to help you block a channel that you're having to pay for, to me that's a bit of Alice in Wonderland behavior here.

And finally, as Senator Brownback brought up, there is this problem of offensive programs which parents don't want and so, it seems to me, they shouldn't be required to block it out if they don't

want it and still pay for it. I'd be glad to hear your response to that generalization and diatribe.

Mr. GOLDSTEIN. Never a diatribe, Senator. I think in general, as I've mentioned, we would agree that à la carte does provide opportunities for choice. We think that over time it may be possible for the industry to work out issues and trying to find some ground in which they could offer some other options. We were told, however, that, whether you even went to mini-tiers or something like that, the same type of business model problems would crop up.

So it's unclear to us, you know, absent simply trying it and understanding what kinds of rates would be set, what kind of consumer choice would exist, what kind of diversity might or might not exist, exactly how it might transpire. But I can sympathize with your—

The CHAIRMAN. Well, let me give you a model, a grocery store. I go down and I buy a loaf of bread. I don't have to buy broccoli and a quart of milk along with it.

Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. Mr. Goldstein, let's look at sports costs, because it seems to me this is a pretty clear example where there are absolutely no incentives to keep sports programming costs down and it seems to me the concept of à la carte pricing might change that. You've got a situation now where in effect the sports channels pay the leagues a gazillion dollars for TV rights and then all of that's made up with the sky-high contracts with sports leagues and teams and the cost of programming just goes up and up.

Start by telling me what incentives exist today to hold down the costs of sports programming.

Mr. GOLDSTEIN. Senator, I'm not really sure that that was part of what we looked at. One of the things that we did find is that if you—

Senator WYDEN. But if you would, tell me what incentives in today's world of pricing would exist. I would just like your opinion, because I've given you an example of why I think à la carte would work in that area. So if you would, in your opinion, tell me what incentives exist today to hold down sports programming costs.

Mr. GOLDSTEIN. I think, Senator, actually when it comes to sports programming, if there was an area where a tiering process could work, the most likely place that it could work would be the sports world, because you have the technology that you would need for a broad à la carte doesn't apply here because it's fairly narrow, you can block. You have a very obviously loyal base of fans that would be eager and willing to have that kind of a property.

But when we talked to the sports leagues and sports networks, we still encountered the same kind of issues that we did more broadly with à la carte in that they were not eager to—they said they would not be eager to sell their programming in that it would limit the size of the audience that would see their shows and obviously affect advertising.

Senator WYDEN. Well, I appreciate your at least saying that this is an area where conceivably it could work, because right now, and it's sort of a textbook for walking through this whole question, there aren't any incentives today, and in fact, all the incentives are

for just paying the leagues a boatload of money. The leagues make up for it with these gigantic contracts and the consumer gets shel-lacked by it, and I appreciate your answer.

Let me ask you if I might about your finding with respect to infrastructure investment. You said that this was one of the key areas that led to price increases. Everybody thinks advanced infrastructure is great, more channels, digital service, high-speed Internet access. But you've got a situation again where a lot of folks are paying for the upgrades, and how is it fair in your opinion if they don't want that?

Mr. GOLDSTEIN. Senator, we didn't—

Senator WYDEN. I'm asking for your opinion. I just would like—you gave me your opinion with respect to sports programming, but give me your opinion on—

The CHAIRMAN. Senator Wyden, could I remind you that they really are asked to conduct studies and they'd like to keep their job.

[Laughter.]

Senator WYDEN. All right.

Mr. GOLDSTEIN. Thank you, Mr. Chairman.

Senator WYDEN. Then how does it ensure that markets are competitive with that kind of approach? That's a factual question. Tell me how that promotes more competitive markets.

Mr. GOLDSTEIN. I think I'll ask Ms. Abramowitz if she would take this for me.

Senator WYDEN. Good.

Mr. GOLDSTEIN. Thank you. She doesn't like her job.

[Laughter.]

Ms. ABRAMOWITZ. I think that the—

Senator WYDEN. This is an area you looked at.

Ms. ABRAMOWITZ. Absolutely. I think that the infrastructure investment that was, you know, very considerable is basically a reflection of the coming competition from the DBS industry. When DBS came into the market in the mid-1990s, most cable systems in this country were not digital, and DBS came in with this huge offering of channels compared to a standard cable package, and that's really what drove that infrastructure investment.

Now, you're right that in the end what it provided to consumers was a variety of services, many of which a particular consumer may not be interested in purchasing. In the market, the prices sort of get set based on what sort of the average consumer is interested in buying, and the number of cable channels did increase dramatically and from before the digitalization to after and I think that's a lot of the reason some of those costs were passed on to consumers, but it also is passed on in the form of digital tiers and cable modem services.

Senator WYDEN. Now, small cable operators in my state, Mr. Goldstein, have said that in order to get a channel they know their subscribers want, sometimes they have to take a bunch of additional channels as well because the same media conglomerate owns the multiple channels and wants them all carried. So, in effect, the local cable operator can't just select the channels it wants.

What I'd like to know is how common is that practice? There are some questions with respect to the statute and it being rooted in retransmission consent, but how common is that?

Mr. GOLDSTEIN. Our understanding is that it's very common. It happens all the time and throughout the country.

Ms. ABRAMOWITZ. Right. I think almost everyone we spoke to described contracts where multiple channels were sold at the same time, particularly if they were broadcast owned.

Senator WYDEN. Well, Mr. Chairman, without asking Mr. Goldstein his opinion with respect to the implications of it, but it seems to me that these answers indicate to me that if an additional, an individual cable system wanted to try a new business model perhaps on the theory that consumers want more choice, my sense is there are a lot of reasons for doing that, and I look forward to exploring with you the ways to get it done. Thank you.

The CHAIRMAN. Thank you, Senator Wyden. Senator Lott.

Senator LOTT. Just one more question in this area, Mr. Chairman, so we can hear the rest of the witnesses. Did GAO's research find evidence that small cable operators are in an unfair bargaining position when negotiating with large media companies for carriage rights of their networks? I assume that's an area you did get into.

Mr. GOLDSTEIN. I do not think that we found that, sir.

Senator LOTT. You don't think they were in an unfair—

Mr. GOLDSTEIN. That they were in an unfair position.

Ms. ABRAMOWITZ. I mean, generally.

Senator LOTT. I'd like to think about that.

Ms. ABRAMOWITZ. Generally, you know, we did speak to 11 cable operators and we made sure that some of them weren't the big guys. That is an issue that they have concern about that they don't know what kind of bargaining or what kind of rates the bigger carriers get, including the DBS carriers that they're directly competing against, but most of that information is within confidential contracts and we didn't see any specifics on how different those prices might be.

Senator LOTT. So there are concerns but you didn't find any evidence that that was actually occurring?

Ms. ABRAMOWITZ. Exactly.

Senator LOTT. Thank you.

The CHAIRMAN. Senator Breaux.

Senator BREAU. Thank you, Mr. Chairman, and thank the panel. I think you all really did a good job overall in the report. I think it's very extensive and you did a good job. Two points—and then a short question—on the comparing the cable rates increases of the CPI I think at best is an unfair comparison. I mean, we struggle with this CPI comparison to everything over a long period of time. It just doesn't work. CPI only reports the increases or decreases in prices of a product. It doesn't consider the cost of producing the product and it doesn't consider increases in the quality of the product. It just says, well, this product sold for \$10 in 1990 and now it's \$20 in the year 2000. It doesn't take into consideration the increase in the cost of producing a product or the quality improvements in the product itself. So at best it's a very unreliable comparison at best.

Second thing, it seems to me that if Congress decides that competition exists in a particular market, no matter what it is, then competition in the marketplace determines what the prices are. If a monopoly exists in something that's essential to the public, well then Congress has a legitimate reason to regulate the prices, the type of service, how they sell that service, how they market that service.

But when Congress has made a decision, as this Congress has, and—well, in 1996—that competition existed sufficiently to deregulate this industry, then in my opinion deregulation means not just deregulating the price they sell the product for, but also certainly deregulating how they advertise and how they market and how they package those products.

If we made that fundamental decision, which we have, then you just can't pick and choose, say, well, we won't regulate the price, we're going to regulate how they market their products. You can't have it like that. It's either a deregulated market or it's a regulated market and there's a legitimate reason for a regulated market when competition doesn't exist, but I don't think your report suggests that when you have 75/21 percent split.

My question is, it seems like your report also is a pretty strong indictment of the FCC's looking at this particular issue. You point out, as we've mentioned, that the FCC survey of cable franchises may actually lead to inaccuracies. That's a pretty strong statement from GAO. Can you elaborate on why you think the FCC, which is in charge of this area, is providing information that may well lead to inaccuracies, because Congress depends on their recommendations.

Mr. GOLDSTEIN. Yes, Senator, we can. In fact, not only did we think that there were inaccuracies, we found inaccuracies when we went through their data. And I'll ask Ms. Abramowitz to detail some of that, but there were inaccuracies in a number of different areas frankly.

Ms. ABRAMOWITZ. Basically we found two things. One was that FCC asks the cable operators to report what were the causes of the rate increases. So for a given rate increase over the year, you know, what were the key factors that caused that. And there was a little confusion among the cable operators we spoke to about how that was supposed to be filled out, and what we found was that different cable operators were doing it different ways. Sometimes even within a cable operator it was being filled out a regional level. There was really no consistency.

Additionally, they asked for that to be reported in a way that the cost changes summed up to the rate change for the year, which is a very regulatory environment kind of a question. The form really did date back to the regulated era. In fact, it sort of wasn't really something that could be reported that way now that they're free to set their rates as they want to. They don't have to justify a rate increase or decrease.

And we made a recommendation to the FCC to change some things on that form and they have done it. The survey that's in the field right now is I understand from FCC officials quite a bit different.

The other area had to do with which franchise areas were deemed to be competitive. FCC's process is basically a legal process laid out in the 1992 law that determines whereby cable operators can submit information that indicates that they face effective competition, a legally defined term, and if FCC finds that that's the case, they grant them effective competition.

When we were doing our study, we wanted to make sure that what was called competitive was competitive from an economic sense, and so we went back and basically looked at every single one of the franchise areas in our model and we found that some places that had had an effective designation at some time in the past really did not have a competitor and vice versa, that there was competition in that area, but that it had never been filed for.

So we made changes for our purposes on that. We also recommended that FCC look at their procedure, but they really feel that they need to stick with some of the legally mandated way that they go about that.

Senator BREAU. Thank you. That's interesting information, because we depend so much on what the FCC tell us in these areas. If they have what I would consider a fundamental flaw in some of their analysis, I mean, that needs to be corrected. In one area you think it is and the other area dealing with effective competition, you look at in sort of an economical technical term as opposed to the real world actually competition, and they haven't changed that and you indicate they probably don't want to change that.

Mr. GOLDSTEIN. Senator, we suggested to them that there were a number of options they might consider, including looking at effective competition not just once but on an occasional basis so they could keep this information updated, and that they felt that really on a cost-benefit basis it would not be useful for them to do that.

Senator BREAU. OK. Thank you all. Thank you for the report. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Smith.

Senator SMITH. Thank you, Mr. Chairman. I'd like to pursue the à la carte option. It's my understanding that there are a number of channels that are now well-accepted and subscribed, the History Channel, maybe Discovery Channel, the Golf Channel, that when they were à la carte weren't making it and were going to die, but when bundled they ultimately attracted enough viewership they could probably survive an à la carte offering.

That leads me to wonder if we're dictating what gets à la carte and what gets bundled. We may miss some programming that ultimately could develop into very popular programming. Could you comment on that? Is my perception accurate in that?

Mr. GOLDSTEIN. I think it is. One of the concerns we had frankly in talking to people was that you would actually be losing some channels and some networks and it's based on lack of viewership that couldn't get enough subscribers, couldn't get enough advertisers.

Senator SMITH. So allowing cable to bundle does help the consumer because it gives us more choices. Is that correct? The economics wouldn't allow some to survive if they were not bundled?

Mr. GOLDSTEIN. That's a distinct possibility. As I said, that is certainly something that was brought up.

Senator SMITH. Isn't that the case with the History Channel in the past, the Golf Channel in the past, Discovery Channel in the past? Do you know?

Mr. GOLDSTEIN. I don't specifically know. Do you know?

Ms. ABRAMOWITZ. I think the Golf Channel we heard that it was an à la carte offering it was first or one some kind of—

Senator SMITH. And was going to die if it did not get bundled?

Ms. ABRAMOWITZ. And it wasn't doing well when it was put on the tier.

Senator SMITH. OK.

Ms. ABRAMOWITZ. But other than that we don't have any specifics.

Senator SMITH. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Allen.

Senator ALLEN. My friend from West Virginia was talking on some other medium. Let me ask you a question, Mr. Goldstein. In your report, Senator McCain, our Chairman, made some good points here. Number one, no price fixing, which is good. At least we have that one off. I do agree with the logic of Senator Breaux though that if you have deregulation and we're going to have competition and primarily the competition is satellites.

The question here, and the issue is a concern for the cost increases, I think that's the main point. If everyone could get cable for \$10-a-month and 250 channels, I don't think we'd be having a concern. Maybe we would, but you don't sell peas on at a time, you sell them by a bag. You buy a bag of apples are cheaper in a bag of apples than one apple.

Senator SMITH. We'll sell them any way we can.

Senator ALLEN. I know, I know, but volume—I'll make you a witness whether you sell peas one by one or cheaper by the pound. At any rate, we're trying to find out what the costs here are, and it seems to me that the cost increases come from two areas. One is programming costs. Second, the infrastructure investments and the labor costs of an operation.

Insofar as the programming costs, and folks, thank gosh the sports leagues are charging more. Well, heck, people want to watch it. Look at the top cable programming. They want to watch ESPN and primarily it's professional football and college football, to a lesser extent other sports.

A constraint that is going to come about, and you're seeing it in hockey, which the Chairman and I are seeming to be the most avid viewers of hockey and we love the sport and it's great live, but it doesn't get the market, their ratings are low. Therefore, the NHL, when they get into their labor agreements, they're going to have to figure out something to make that league economically viable because they can't get the revenue, as much as Mr. Eisner love their Mighty Ducks and ESPN, nonetheless they don't get the viewership. Therefore, they can't sell the ads because people are watching it and they're not going to get the revenue. Football does get the revenue.

I am not one who thinks that the government ought to be complaining about what any entertainer receives for getting on stage and singing, performing, or for those athletes who are for a short time of their life be able to make some money while also risking

injury. And so the fact that they get paid a lot of money, that's the marketplace all working in a whole large sense of the way it ought to be, and it's consumer demand and their attraction.

Now, you get into the infrastructure investments and labor costs. In these areas, can you from GAO give us the reflection of the cost in programming, infrastructure investments and labor costs and how they have increased in recent years as a percentage in those different areas? Because I've seen a figure that shows cable has invested—this is all cable companies—about \$75 billion in investments over the years. The programming is better, of better quality, in addition to the opportunity for broadband.

But if you figure \$75 billion, that comes out to about \$1,000 of investment per customer, so if you could verify from your accounting procedures and surveys, how much of an increase has there been in programming costs, how much of an increase, percentage increase, has there been in the costs of upgrading the system to make cable viewing more attractive? And whether or not cable viewing has increased by viewers obviously due to those upgrades in the infrastructure.

Mr. GOLDSTEIN. Sure. Let me try to help you a little on that, Senator. We found that with respect to programming overall, it had gone up 34 percent. Sports programming had gone up 59 percent in the 3-year period that we looked at it.

With respect to infrastructure, we did not and were unable to really distinguish between the components of it, given the way the market works today in an unregulated environment in terms of, obviously people are better off in cable because there are—infrastructure has helped provide better quality, more channels. But obviously infrastructure investments have also been used to improve other things, other services that the industry provides.

So in that way we were not able to sort of segregate out and separate the components of it.

Senator ALLEN. Do you have a—is the \$75 billion, did you find that the—

Mr. GOLDSTEIN. Yes, sir, that's the figure that we use, \$75 billion that we found.

Senator ALLEN. And how many cable subscribers are there?

Mr. GOLDSTEIN. I believe it's about 70 million, sir.

Senator ALLEN. So \$1,000 per customer is a—

Mr. GOLDSTEIN. You're in the ballpark.

Senator ALLEN.—ballpark figure, using a sports analogy, might as well. Have you noticed what are the most popular—while the increase in sports programming, those increases are 59 percent, have you been able to determine if viewership of sports programming has gone up over this period of time?

Mr. GOLDSTEIN. I don't think we specifically looked at that for this report, sir.

Senator ALLEN. The ratings, all right, that's more for them. Have you found—were you able to determine whether or not people are watching cable TV more with these upgrades than they had been previously?

Mr. GOLDSTEIN. We reported on other studies and other things in our report that certainly suggest that there is more viewership and that even there are some studies out there that would show

that the cost per viewer hour has gone down as a result of—that people are watching, that people certainly are watching more. There's more to watch and they're watching it more of the time.

Senator ALLEN. So what you're—by that logic, they're getting more value.

Mr. GOLDSTEIN. That is certainly one—one can say that.

Senator ALLEN. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Rockefeller.

**STATEMENT OF HON JOHN D. ROCKEFELLER IV,
U.S. SENATOR FROM WEST VIRGINIA**

Senator ROCKEFELLER. Thank you, Mr. Chairman. Mr. Goldstein, there are a lot of independent, smaller operators, you've already referred to them, that have cable networks and they worry a lot about media consolidation because they say that when that happens it makes it very difficult for them to obtain carriage of what they have to offer from cable and satellite operators on fair terms. Now, you've already addressed the concept of fair terms. I was a little bit confused by that.

So you say specifically in your testimony that cable networks owned by broadcast or cable operators are 46 and 31 percent more likely to be carried than independent, smaller independent networks, of which you say there are many. In your view, why is that and why should that be allowed to stand?

Mr. GOLDSTEIN. I think we found that really only 38 percent of the networks are still independent, are not carried by their broadcaster or a cable operator. We don't really have an opinion on whether it should be allowed to stand or not in that instance, but it clearly is an instance of consolidation and perhaps is one that ought to be looked at more.

Senator ROCKEFELLER. That is an issue?

Mr. GOLDSTEIN. Yes, sir.

Senator ROCKEFELLER. Second question is, in your testimony you have an interesting sentence. You say adopting an à la carte approach where subscribers choose to pay for only those networks they desire, which is kind of an American concept, would provide consumers with more individual choice, and so you're kind of rocketing off on a sentence here. And then it changes sharply, but could require additional technology that could alter the current business model of the cable network industry, et cetera, et cetera, et cetera.

And my reaction to that is that may very well be true on a temporary basis, but there's always alteration of technology, there are always costs involved. But allowing people essentially, I mean, if it's an ESPN or Outdoor Life that my folks from West Virginia want to watch and they don't want to watch a whole lot of other things, I mean, just here in Washington you have to go through dozens and dozens of things that you never ever watch to try and find what you do want to get.

Why are you so concerned about the predictable additional costs of making adjustments, as opposed to the end result, which is consumers getting what they want and only paying what they want?

Mr. GOLDSTEIN. Senator, I don't think that we are against it frankly. I think all we're saying is that there are impediments that we were told about that we wanted to report to the Congress. It's

obviously a policy issue for Congress to ultimately decide whether or not to forward.

Senator ROCKEFELLER. You say it doesn't overshadow à la carte. It just happens to be in the same sentence. It overshadows the first part of your sentence.

Mr. GOLDSTEIN. We may have an editing issue. But in essence I don't, again, we don't really have a position on it. The press, when we came out with this report, indicated that GAO was against à la carte. I don't believe that we are against it. We simply felt that it was important to talk about the impediments that we were being told by the industry that would exist for à la carte.

Senator ROCKEFELLER. Would they not be short-term impediments, though, one-time impediments for the most part?

Mr. GOLDSTEIN. Certainly the technology, the addressable set-top box issue, the technology issue will go away over some period of years, no question, maybe shorter than longer depending on who you ask. There's no question about that at all. Obviously there are larger issues that would have to be dealt with by the industry in terms of the business model and making that more effective if a la carte was going to be implemented.

Senator ROCKEFELLER. Thank you.

The CHAIRMAN. Senator Snowe.

**STATEMENT OF HON. OLYMPIA J. SNOWE,
U.S. SENATOR FROM MAINE**

Senator SNOWE. Thank you, Mr. Chairman. Obviously it's disconcerting these cable rates have gone up more than 40 percent over the last 5 years and 85 percent of our households have cable service in America. So it is in our interest to make it as affordable as possible. We deregulated. We recognized that hopefully there would be some price competition, so it's interesting to examine some of the factors that have contributed to driving up the escalating costs of basic cable rates.

And I know that the GAO report examined the à la carte approach. Did you ever look at sub-tiering packages? Because could that be a hybrid alternative to looking at the à la carte approach, which I recognize could have some adverse consequences. But what about doing some sub-tiering packaging? For example, have a sports channel package or a family package or old movies package or whatever? To break down some of the basic packages, not to three or four, but to an array that offers consumers choices.

I think that's the issue here. Is there another way of exploring this issue without contributing to further escalating the increases, or obviously having an adverse impact on the cable industry?

Mr. GOLDSTEIN. Senator, I think we—I would answer in two ways. One way is that I'd indicated a little earlier that with respect to a sports tier, that if there were any kind of tier that might be implementable in sort of—that could be done fairly easily, it would be a sports tier given that the technology for doing a simple tier like that would not be a problem. There's obviously a loyal fan base there.

But I also indicated that the kind of issues that came up with à la carte in general were raised by the sports leagues and the sports networks in our discussions with them.

We also have talked about mini-tiers and we discussed mini-tiers as well as broad à la carte in our report, and the industry and the financial analysts and advertising executives that we talked to said that the business model kinds of issues would not change with respect to mini-tiers either, that it's the same issues frankly in their opinion.

Senator SNOWE. You mean, it would change, it would still change advertising behavior?

Mr. GOLDSTEIN. That's correct. That was their view.

Senator SNOWE. So you couldn't do any alterations with the current approach?

Mr. GOLDSTEIN. That was, I mean that was certainly the view of most of the people that we talked to, that's correct, that the difficulties—

Senator SNOWE. But you examined the à la carte approach, that they would start from scratch and picking and choosing which services and programming they would use, but could you do something beyond that that is broader in categories?

Mr. GOLDSTEIN. I mean, you might be able to. We would have to look at it more. We did not do that.

Senator SNOWE. I see. What about the retransmission costs? I mean, the impact of retransmission and must carry on some of the programmings with basic networks, do what extent does that contribute to increasing the costs?

Mr. GOLDSTEIN. I think we found sort of a mixed bag there and I'll ask Ms. Abramowitz actually to answer that if she will.

Ms. ABRAMOWITZ. We looked directly at whether license fees for cable networks that were owned by broadcasters were higher than license fees for other cable networks, and we did it a couple of ways, trying to hold constant the popularity of the network, whether it was a sports network, how long the network had been around. We didn't find the license fees, broadcast, cable-owned—rather, broadcast-owned cable networks to be higher.

We did that work because we did hear from a variety of cable networks and cable operators that they felt that these rates were higher. So we did not find evidence of a price differential on the license fee. We did, however, as I think Mark mentioned, find that those networks were more likely to be carried by cable operators.

Senator SNOWE. What contractual factors contributed, because you said technological, economic, and contractual factors explain the practice of grouping networks?

Mr. GOLDSTEIN. Our understanding from our discussions is that most of the networks, this is required in their contracts to be, for the tiers that they're placed on.

Senator SNOWE. And so does that limit consumer choices?

Mr. GOLDSTEIN. Sure.

Senator SNOWE. So are there any other ways of examining the, I think the fundamentals of the way in which the programs are grouped that could offer choices to consumers beyond a la carte, based on what you know?

Ms. ABRAMOWITZ. I guess the one thing that we would say definitely came out of our work was that going forward on the digital tiers there are more often mini-tiers within digital tiers that you can buy, and a lot of people we spoke with did say that that's the

future, that there is probably going to be more choice as the society in general moves to digital tiers, HD tiers, and so forth to be able to have more choice on the consumer side.

Senator SNOWE. I see. So you have to move on digital in order to get that, because they do it now?

Ms. ABRAMOWITZ. Well, then you have the set-top boxes that gives the cable operator the opportunity to target what exactly you want.

Senator SNOWE. There's going to be some, I think that it's anything else is sort of the balance that has to be struck in this process. Obviously we don't want to turn the whole industry on its head and we understand that advertising is important, but on the other hand, consumers also deserve choices. Cable is part of the way in which most households in America receive their entertainment, the news and otherwise, and so when it's limiting those choices, when we went to deregulation, there's going to be competition, there has been consolidation in the industry. That's the other factor.

Would you say that that's also contributed to escalating rates as well, because it limits competition?

Mr. GOLDSTEIN. We—when we looked at the issue of consolidation of licenses, we did not find that there was an ownership effect on license fees just on carriage, so we did not find actually—

Senator SNOWE. Just on carriage, yes.

Mr. GOLDSTEIN.—a price increase.

The CHAIRMAN. Senator Cantwell.

**STATEMENT OF HON. MARIA CANTWELL,
U.S. SENATOR FROM WASHINGTON**

Senator CANTWELL. Thank you, Mr. Chairman. Mr. Goldstein, I know we've been talking a lot about business models here in the digital age. I know your report dealt a little bit with the availability of content, but I'm just struck. I ran across a Wired article that said the future will be fast, but it won't be free, in which basically it said flat-rate billing isn't commercially viable in an era when consumers consume 1,000 times as much data as another consumer. And if you're downloading a million bits-per-second, the cost of those bits aren't trivial anymore and that entertainment companies who are peddling video online really need to look at pay-per-view, pay-per-hour, as the logical consequences.

So I know you looked more clearly at the models that exist today and a little bit about the competition in satellite and DBS. But aren't we really talking about the digital era drastically being able to change the delivery system of bits and measure that for consumers and then thereby allow for a different development of business models?

Mr. GOLDSTEIN. Senator, there are probably lots of models you could look at. I think that's right, but I confess they weren't part of the study that we did, so it's really hard for me to respond to that question.

Senator CANTWELL. Well, I understand it probably is, it's probably a more logical question from some of those in the audience, but yet it's really hard for an industry to embrace changing their business models, and I'm sure the music industry probably had a

heart attack when they realized that consumers could pay for one song and download it as opposed to a CD with 14 songs on it.

Mr. GOLDSTEIN. No question.

Senator CANTWELL. But I think that they are starting to embrace that. I have a specific question though. Did you look at the issue of whether programming should be available over IP as an additional source of competition in programming?

Mr. GOLDSTEIN. We did not directly, no. We did note obviously that the industry is changing, but we didn't look at any specific other ways that it would be—

Senator CANTWELL. Since the satellite—you note that it did provide some competition. Wouldn't that provide additional competition in business models for consumers if more content and programming was just available over IP?

Mr. GOLDSTEIN. Sure, certainly would.

Senator CANTWELL. And don't you think that in general that who's going to be able to tell in 5 years who these companies are? Aren't cable companies going to be into telecom voice over IP and aren't telecom companies going to be into digital video delivery?

Mr. GOLDSTEIN. Sure. You don't need a crystal ball to see that coming, absolutely.

Senator CANTWELL. OK. Well, I guess I'll—

Mr. GOLDSTEIN. But again, we didn't go into that in our study.

Senator CANTWELL. And why not? I'm just curious as to why not.

Mr. GOLDSTEIN. It simply, it wasn't among the objectives that we talked about with the Committee and how we developed the study initially.

Senator CANTWELL. But if you see it as a crystal ball, don't you see it also as a harbinger of opportunity for consumers to get more?

Mr. GOLDSTEIN. It's clearly something that ought to be looked at more, no question about it. Within the confines of what we were looking at at this point, we didn't include it.

Senator CANTWELL. OK, thank you, Mr. Chairman.

The CHAIRMAN. Senator Sununu.

**STATEMENT OF HON. JOHN E. SUNUNU,
U.S. SENATOR FROM NEW HAMPSHIRE**

Senator SUNUNU. Thank you, Mr. Chairman. I want to begin by stressing a distinction that I think needs to be made in these discussions, and that's the distinction between choice and diversity. We talk about consumer choice and we want to empower consumer to decide what they want to buy, what they want to order, what they want to see, and there's something very American about that.

But that is really distinct from the concept of diversity, which is the number of channels that they might get to choose from, the range, the breadth, the scope of the programming, and the difference between the channels. And they're not the same and I think to point that out we can go back to some of the questions Senator Rockefeller was asking about and the response was, well, if you mandate à la carte or you mandate an à la carte system, there might be some technology upgrades and he made the point that those might be one-time costs and indeed they might.

But I would argue that with mandated à la carte or any mandated choice system, even if we think it's a good idea, there are

other costs that may be permanent, costs associated with a shift in advertising dollars, a reallocation of advertising dollars, and a change in economics of some of these channels, like the History Channel I think was mentioned, Arts and Entertainment, and those are true costs if those channels are no longer available.

So there may be one-time technological costs, but there are other costs that may actually limit the diversity and limit the scope of programming that's available even as we achieve what we may think is an important objective of giving consumers more power. So I want to keep those two concepts separate as we pursue these ideas.

It was mentioned briefly but I want to get your numbers if you have them available that a cost per viewer hour was going down. I thought that was interesting. I thought I saw some smiles when someone equated length of viewing as an increase in value. And that may well be the case, but did you track cost per viewer hours and what has happened to those numbers over time?

Mr. GOLDSTEIN. Senator, that was not our study. We mention as a footnote in our study that there is an academic study that came out not long ago that does talk about.

Senator SUNUNU. And can you—do you recall what the figures were, what the rough decline was in the cost per hour viewed?

Ms. ABRAMOWITZ. It was a very slight reduction in the price when you take into account over, I don't know how many years, the number of—the fact that people view more cable. I mean, a lot of it's a shift from broadcast viewing to cable viewing.

Senator SUNUNU. It was flat, maybe a slight reduction in cost.

Ms. ABRAMOWITZ. I can't remember the exact number.

Senator SUNUNU. And, of course, no characterization made for the quality of the programming, I assume. Can you think of any other product or industry where government regulates an à la carte pricing structure or a pricing regulation similar to the à la carte proposals that you considered in your study?

Mr. GOLDSTEIN. Not off the top of my head, but again, it wasn't part of what we looked at. It probably would be useful to do that in the future if Congress was looking to adopt this.

Senator SUNUNU. Well, it certainly is helpful to have some kind of analogous situation where you can determine what the actual impact is on customers. And finally, you say there was no correlation between price and consolidation or affiliation among the cable provider and the networks or consolidation within the industry?

Mr. GOLDSTEIN. We specifically looked for it and we did not find it.

Senator SUNUNU. Did you look hard?

Ms. ABRAMOWITZ. It was the license fee, it wasn't the price to consumers. So we were looking to see, did network A with these characteristics but owned by a broadcast network, was it higher license fee than network B that had similar characteristics in terms of like how popular it was. And we looked at that statistically and didn't find any difference.

Senator SUNUNU. Terrific. Well, I appreciate your work and I appreciate the fact that it was actually a very readable study. That's always helpful. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. I want to thank you, Mr. Goldstein, and I would point out that you point out cable operators who have invested large sums in upgraded infrastructures, which generally permit additional channels, digital service, et cetera, and those expenses are now being borne by analog customers. I think there's a fundamental unfairness associated with that. We'll pursue that with the next panel. I thank you very much.

Our next panel, Mr. Jim Robbins, President and CEO of Cox Communications; Mr. George Bodenheimer, President of ESPN and ABC Sports; Mr. Gene Kimmelman is the Director of Consumers Union; the Honorable Marilyn Praisner of the Montgomery County Council; and Mr. Rodger Johnson, President and CEO of Knology, Incorporated.

Thank you witnesses for being here. Thank you for their patience, and Mr. Robbins, I want to assure you that we are happier that you're back than you are happy to be back. Thanks. And I would like to say, Mr. Robbins, we do appreciate your continued willingness to come and testify before this committee. We do appreciate that, even if sometimes you and I might disagree from time to time, but I do appreciate your willingness and cooperation with this committee. I think it's been very helpful to process. We'd like to begin with you.

**STATEMENT OF JAMES O. ROBBINS, PRESIDENT AND CHIEF
EXECUTIVE OFFICER, COX COMMUNICATIONS, INC.**

Mr. ROBBINS. Thank you, Mr. Chairman, and one old Navy guy likes to help out another old Navy guy any way we can. I will commend you on the number of Senators. I don't think I've seen so many in one place since watching C-SPAN.

The CHAIRMAN. I think they are hearing from their constituents.

Mr. ROBBINS. Well, Mr. Chairman, distinguished Members of the Commerce Committee, thank you for the opportunity to join you again about cable television prices. As you are aware, the GAO's analysis confirms that cable price increases reflect significant expenditures by cable operators in infrastructure, programming, and customer service.

The consumers have benefited tremendously from Cox Communication's network and customer service improvements. Since 1996, Cox has invested considerably more than \$12 billion of private risk capital to provide consumers and businesses digital video, high-speed Internet, local and long-distance telephone service. For cable TV customers, this investment translates into improved picture quality, highly reliable service, and more channel choices.

Our investment has also created the most robust high-speed Internet service on the market today and an unprecedented competitive choice for facilities-based lifeline local and long-distance telephone service.

With these advanced products have come considerable customer service improvements due to our investment in technology, skilled talent, and training. The end result for our customer is a tremendous value proposition, great convenience, and high satisfaction correlates directly to Cox's infrastructure and customer service investments.

Keeping cable TV affordable is a business imperative for Cox. We are on the same side as you on that one. Due to formidable competition from direct satellite, direct broadcast satellite and other providers, this year Cox's average price adjustment is approximately 3 percent, down from 5.3 percent last year, and those are both well below industry average.

That price discipline, coupled with Cox's technological advances and superior customer care, has resulted in lower DBS penetration in Cox markets, about half the industry average. But price discipline is increasingly difficult in the face of a rapid, unrestrained rise in the cost of programming, as affirmed in the GAO report. Cable price increases are driven largely by rapidly rising programming costs.

Over the past 3 years, FCC and GAO data indicate that sharply rising programming costs are the largest driver of increased cable prices. I have submitted for this hearing record an economic paper by William Rogers, a Northwestern University professor and former FCC chief economist. The paper demonstrates that for the period studied from 1999 to 2002, rising programming costs accounted directly for 42 percent of cable price increases across the industry.

At Cox, the number is even higher because our retail rate increases are significantly less than the industry average. From 1999 to 2002, more than half of our rate increases were directly attributable to programming cost increases. In 2002, that number was 66 percent, meaning that after covering direct programming cost increases, one-third of what we took in was left to cover all other increases, indirect costs including labor, customer service, and technology investments.

A significant contributing factor in the rise of programming costs is the continued misuse of the retransmission consent right. If Congress wants to address the problem of rising cable rates, it should consider reforming retransmission consent, particularly as it is being used for the big four television networks to foist unwanted challenges at inflated prices on cable customers.

Since retransmission consent was legislated in 1992, numerous channels have been added to Cox Cable customers' channel lineups at additional cost, primarily due to retransmission consent negotiations, not because of consumer need, choice, or demand.

In addition, license fees for existing cable channels affiliated with broadcast networks have increased significantly due to the leverage created by the ability of these broadcast networks to withhold distribution of their local stations.

It is troubling to me that a consumer in Roanoke, Virginia, as an example, may be required to pay more for a cable channel because a broadcast network is leveraging its retransmission rights. That misuse of retransmission consent in no way benefits, for example, the local viewers of network-owned and operated station in Orange County, California. It only benefits the media conglomerate that owns the station.

Contrary to the findings of the GAO's case study wire-lined overbuilds in Cox markets have had little impact on Cox's cable rates, which reflect the steep fee increases we're facing for cable programming. In fact, as submitted in detail for the record of this hearing,

Cox Cable prices are virtually the same in Cox markets that face overbuild competition as they are in those that do not.

We continue to increase the value proposition for our customers as we introduce numerous service enhancements, including digital cable, high-definition television, digital video recorders, and entertainment on demand. Introduction of new technology also means enhanced tools to give parents more control over what their children are watching, including V-chip and program blocking. In particular, digital technology provides a highly secure, encrypted environment for all adult programming as well.

For analog customers, Cox is providing traps to help them block programming they find unpalatable. And finally, Cox is launching a company-wide consumer education program to help parents understand all of their parental control options, as well as where to find all the great family friendly programming that's available on cable. Meanwhile, Cox customers continue to have access to a low-priced, regulated, lifeline basic-tier priced at roughly \$12 a month featuring 15 to 25 channels of programming.

The GAO report notes that the à la carte sale of cable networks could drive up costs for cable customers. We agree. This technical and economic model does not work and is not in consumers' best interests, as it results in higher prices and fewer program choices.

Competition is working and that, in our judgment, is what best serves American consumers. The GAO report agrees that competition spurs investment and provides more choice and value for consumers. Robust competition exists today in among cable operators, DBS providers, overbuilders and telephone companies. That competition will keep prices in check for the benefit of American consumers.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Robbins follows:]

PREPARED STATEMENT OF JAMES O. ROBBINS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COX COMMUNICATIONS, INC.

Mr. Chairman and distinguished members of the Commerce Committee, thank you for the opportunity to again join you to testify about cable television prices.

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Consumers have benefited tremendously from Cox Communications' network and customer service improvements.

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For cable TV customers, this investment translates into improved picture quality, highly reliable service and more channel choices. Our investment also has created the most robust high-speed Internet service on the market today and an unprecedented competitive choice for facilities-based, lifeline local and long distance telephone service. With these advanced products have come considerable customer service improvements, due to our investment in technology, skilled talent and training.

The end result for customers—a tremendous value proposition, great convenience and high satisfaction—correlates directly to Cox's infrastructure and customer service investments.

Keeping cable TV affordable is a business imperative for Cox, due to formidable competition from Direct Broadcast Satellite and other providers. This year, Cox's average cable price increase is approximately 3 percent, down from 5.3 percent last year, and well below the industry average. That price discipline, coupled with Cox's technological advances and superior customer care, has resulted in lower DBS penetration in Cox markets—about half the industry average.

But price discipline is increasingly difficult in the face of the rapid, unrestrained rise in the cost of programming. As affirmed in the GAO report, cable price increases are driven largely by rapidly rising programming costs.

Over the past three years, FCC and GAO data indicate that sharply rising programming costs are the largest driver of increased cable prices. I have submitted for this hearing record an economic paper by William Rogerson, Northwestern University Professor and former FCC chief economist. This paper demonstrates that, for the period studied from 1999 to 2002, rising programming costs accounted *directly* for 42 percent of cable price increases across the industry. At Cox the number is even higher, because our retail rate increases are significantly less than the industry average. From 1999–2002, *more than half* of our rate increases were directly attributable to programming cost increases. In 2002, that number rose to 66 percent, meaning that after covering direct programming cost increases, just *one-third* of our price increases were left to cover ALL other increased indirect costs, including labor, customer service and technology investments.

A significant contributing factor in the rise of programming costs is the continued misuse of retransmission consent rights. If Congress wants to address the problem of rising cable rates, it should consider reforming retransmission consent, particularly as it is being used by the Big Four television broadcast networks to foist unwanted channels, at inflated rates, on cable customers. Since retransmission consent was legislated in 1992, numerous channels have been added to Cox Cable customers' channel lineups, at additional cost, primarily due to retransmission consent negotiations—*not* by consumer need, choice or demand. In addition, license fees for existing cable channels affiliated with broadcast networks have increased significantly, due to the leverage created by the ability of these broadcast networks to withhold distribution of their local stations. It's very troubling to me that a consumer in Roanoke, Virginia may be required to pay more for a cable channel because a broadcast network is leveraging its retransmission rights. That misuse of retransmission consent in no way benefits, for example, the local viewers of the network-owned and operated station in Orange County, California—it only benefits the media conglomerate that owns the station.

Contrary to the findings of the GAO's case study, wireline overbuilds in Cox markets have had little impact on Cox's cable rates, which reflect the steep fee increases we're facing for cable programming. In fact, as submitted in detail for the record in this hearing, Cox Cable prices are virtually the same in Cox markets that face overbuild competition as they are in those that do not.

We continue to increase the value proposition for Cox Cable customers as we introduce numerous service enhancements including digital cable, HDTV, Digital Video Recorders and Entertainment-on-Demand. The introduction of new technology also means enhanced tools to give parents more control over what their children are watching, including the V-chip and program blocking. In particular, digital technology provides a highly secure, encrypted environment for adult programming, as well. For analog customers, Cox is providing traps to help them block programming they find unpalatable. And finally, Cox is launching a companywide consumer education program to help parents understand all of their parental control options, as well as where to find all of the great family-friendly programming available on cable. Meanwhile, Cox customers continue to have access to a low-priced, regulated lifeline basic tier, priced at roughly \$12 a month, featuring 15 to 25 channels of programming.

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Competition is working and best serves American consumers.

The GAO report agrees that competition spurs investment and provides more choice and value for consumers. Robust competition exists today among cable operators, DBS providers, overbuilders and telephone companies and will keep prices in check, to consumers' benefit.

Thank you.

ATTACHMENT

THE GAO REPORT: AN ACCURATE ASSESSMENT OF CABLE PRICE INCREASES AND THEIR UNDERLYING CAUSES

Bottom Line

The GAO Report supports Cox's long-standing positions on a range of important issues, including: (1) the legitimate business factors, including programming cost increases, that contribute to cable service price increases; (2) the competitive state of the video programming marketplace; (3) the pernicious effects of rising sports programming costs and TV network retransmission consent negotiations on cable customers; and (4) the reliance on competition, rather than regulation, as the best means of protecting consumers' interests.

Rate Increases

The GAO Report concludes that: "Several key factors—including programming costs and infrastructure investments—are putting upward pressure on cable rates. . . . Additionally, cable operators have increased spending on customer service, which typically is now available 24 hours a day, 7 days a week." Report at 4–5. These increased costs are not all being passed through to basic cable customers, however. According to GAO, "most franchises told us that their actual annual cost increases for the year covered by the 2002 survey exceeded their rate change for expanded basic service." Report at 14.¹

Statistics included in the GAO Report, the FCC's Annual Rate Survey and other industry studies indicate that, between 1999 and 2002, programming cost increases in particular accounted for a large share of all basic cable price increases. Although programming costs represented a smaller percentage of total cable operator costs over that time period, they played a much larger role in basic cable service price increases.² Indeed, because Cox's rate increases have been lower than the industry average, the effect of programming cost increases on Cox's basic cable price increases has been even more significant: programming cost increases accounted for more than half of Cox's basic cable price increases from 2000 to 2003, and they represented two-thirds of Cox's basic cable rate increases last year.

While Cox's programming costs have increased on average 12 percent annually since 2000, its basic cable prices on average have increased annually less than 6 percent. Over the past four years, the price for Cox's lifeline basic service has increased even more slowly, rising just 3 percent from \$11.66 in 1999 to roughly \$12.00 in 2003.

Video Competition

GAO has found that "[c]ompetition from wire-based and DBS operators leads to lower cable rates and improved quality and service among cable operators." Report at 3. In particular, the Report concludes that "DBS has become an important competitor to cable operators nationwide." Report at 10.

In the face of these competitive pressures, Cox's cable price increases have been moderated and are below industry averages. Cox also has taken a variety of steps to enhance the value of its products, to the benefit of video and non-video customers alike. Cox customers continue to have access to a low-priced, lifeline basic tier, which is priced at roughly \$12.00 a month and typically includes 15 to 25 channels of programming (such as local over-the-air television stations, PEG and leased access channels, a TV channel guide and public service channels such as C-SPAN). Cox's expanded basic offering is purchased by roughly 95 of its video customers and, on average, contains 45 to 55 channels for around \$26.50. In recent years, Cox also has launched advanced video services, including digital cable tiers, HDTV, Digital Video Recorder (DVR), and entertainment-on-demand, all of which have been enthusiastically embraced by its customers.

In addition, to better compete in the marketplace, Cox has successfully launched an array of non-video services, including high-speed Internet access (with approximately 1.8 million customers) and local residential phone service (with over 900,000 customers). Each of these services has been enthusiastically embraced by Cox's customers, is competitively priced, and has brought much-needed competition to its respective industry sector.

¹As GAO observes, "in unregulated markets, . . . costs are an important factor in price setting by companies, but several other key factors, such as consumer demand and the competitiveness of the market, also influence the market price. Thus, costs and prices need not move in tandem." Report at n. 16.

²See "Correcting the Errors in the ESPN/CapAnalysis Study on Programming Cost Increases," by William P. Rogerson, Professor of Economics, Northwestern University.

Sports Programming Costs

The GAO Report found that “[p]rogramming costs incurred by cable operators have risen considerably—on average by as much as 34 percent—in the last 3 years and, in particular, programming costs associated with cable networks showing sporting events have risen even more—on average by 59 percent—during the same time frame.” Report at 4. “Conversely, for the 72 nonsports networks, the average increase in license fees for the same period was approximately 26 percent. Further, the average license fees for the sports networks were substantially higher than the average for other networks.” Report at 22.

In Cox’s experience, sports programming prices are skyrocketing. Today, Cox customers pay \$2.61 for ESPN alone—an amount equivalent to the costs of the other seven top-rated cable networks combined. Some sports networks are seeking up to 35 percent annual rate increases. Yet less than a quarter of Cox’s customers are avid sports fans. Indeed, ESPN and Fox Sports together account for just 8 percent of viewing, but a full 32 percent of Cox’s programming costs.

Although the GAO Report raises a number of important concerns about a pure a la carte approach, it observes that “[c]reating a separate tier for sports channels may be viable because this genre of programming has a loyal base of customers.” Report at 6. At present, Cox is contractually obligated by the powerful sports channels to place them on Cox’s most popular programming tier.³ As a result, virtually all of Cox’s customers are forced to foot the bill for this expensive programming and its exorbitant annual rate increases. If the sports networks do not moderate their annual rate increases to a reasonable level, Cox will explore the possibility of placing them on a separate sports tier. In order to maximize consumer welfare, however, this decision must be made by Cox in discussions with cable programmers, and not by government regulators.⁴ Reasonable marketplace behavior by sports channel owners, not government legislation, is the answer.

Retransmission Consent

GAO documents the expanding vertical integration of the broadcast networks into cable programming. In particular, the Report finds that cable networks today are far more likely to be majority-owned by one of the four major television networks than they are to be majority-owned by cable operators: Of the 90 cable networks that are most frequently carried on cable operators’ basic or expanded basic tier, “approximately 19 percent were majority-owned (*i.e.*, at least 50 percent owned) by a cable operator,” while “approximately 43 percent of the 90 networks were majority owned by a broadcaster.” Report at 26–28.

Retransmission consent has been an important tool used by the television networks to obtain cable carriage of their affiliated cable networks. According to GAO, retransmission consent agreements “often include, as part of the agreement between cable operators and broadcasters for the right of the cable operator to carry the broadcast station, a simultaneous agreement to carry one or more broadcast-owned cable networks.” GAO also cites numerous reports that, as a result, “cable operators sometimes carry networks they might not otherwise have carried, and this practice can make it difficult for independent cable networks to be carried by cable operators.” Report at 29. GAO accordingly recommends that policymakers should “review[] whether changes to the retransmission consent process should be considered.” Report at 6.

Like many cable operators, Cox has been met with frequent demands from the major TV networks in retransmission consent negotiations that it carry network-affiliated cable channels that its customers may not want in order to secure carriage of the networks’ owned-and-operated television stations. Cox agrees with GAO that the major television networks’ retransmission consent tactics warrant further investigation.

Competition, Not Regulation, Is the Answer

GAO correctly concludes that competition in the video marketplace protects consumers’ interests. Report at 6 (“Although re-regulation of cable rates stands as a possible option, taking steps to promote competition would help to reduce cable rates by leveraging the normal workings of the marketplace.”)

³ See also GAO Report at 33–34 (“one individual responsible for negotiating program contracts for cable operators noted that all of the top 40 to 50 networks specify that their networks appear on either the basic or expanded-basic tier”).

⁴ See “*Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Decision Makers*,” by Professor William P. Rogerson, Professor of Economics, Northwestern University.

Cox agrees that the private sector, not the government, holds the key to moderating cable price increases in the future. Cox will continue its longstanding efforts to curb operating cost increases within its control. But cable programmers and operators also must work closely together to develop reasonable approaches to programming cost increases so that cable prices can increase more moderately in the future.

**Cox Cable Rates in Cox Systems Facing Competition
From Wireline Overbuilders**

January 1, 2002			Cox Pricing	
Overbuilder	City	State	Basic only Tier	Highest Priced Tier that includes all non premium, non digital channels
Newhouse	Bakersfield	CA	\$ 15.90	\$ 35.00
Sun Tel/CommSouth	Houston County	GA	\$ 9.80	\$ 33.90
Watson Cable	Warner Robins	GA	\$ 9.80	\$ 33.90
Watson Cable	Centerville	GA	\$ 9.80	\$ 33.90
Suburban Cable	Macon	GA	\$ 9.80	\$ 33.90
Suburban Cable	Bibb County	GA	\$ 9.80	\$ 33.90
Brighthouse	Ocala	FL	\$ 8.85	\$ 35.25
Grande Comm.	Midland	TX	\$ 12.05	\$ 37.73
Grande Comm.	Leander	TX	\$ 6.55	\$ 32.80
Grande Comm.	Pflugerville	TX	\$ 6.55	\$ 32.80
CableAmerica	Mesa	AZ	\$ 13.95	\$ 37.95
Qwest	Gilbert	AZ	\$ 13.95	\$ 37.95
Qwest	Scottsdale	AZ	\$ 13.95	\$ 37.95
Qwest	Phoenix	AZ	\$ 13.95	\$ 37.95
Qwest	Peoria	AZ	\$ 13.95	\$ 37.95
Qwest	Chandler	AZ	\$ 13.95	\$ 37.95
Qwest	Glendale	AZ	\$ 13.95	\$ 37.95
Qwest	Maricopa Co	AZ	\$ 13.95	\$ 37.95
Qwest	Paradise Valley	AZ	\$ 13.95	\$ 37.95
Ultronics	Chula Vista	CA	\$ 12.00	\$ 36.25
Ultronics	National City	CA	\$ 12.00	\$ 36.25
Time Warner	San Diego	CA	\$ 12.00	\$ 36.25
Time Warner	Poway	CA	\$ 12.00	\$ 36.25
Adelphia	Encinitas	CA	\$ 12.00	\$ 36.25
Adelphia	San Marcos	CA	\$ 12.00	\$ 36.25
Craw-Kan	Arma	KS	\$ 10.35	\$ 38.72
Craw-Kan	Franklin	KS	\$ 10.35	\$ 38.72
RCN-PEPCO	Stafford	VA	\$ 12.70	\$ 40.40
RCN-PEPCO	Falls Church	VA	\$ 12.70	\$ 40.40
US West	Omaha	NB	\$ 12.50	\$ 35.45
WideOpenWest	Fairview Park	OH	\$ 8.30	\$ 30.89
GET, LLC	Blackwell	OK	\$ 6.88	\$ 19.00
Service One	Placquemine	LA	\$ 8.98	\$ 37.25
Average Rates for Cox Systems Facing Wireline Overbuild Competition			\$ 11.49	\$ 35.85
Average Rates for All Cox Systems			\$ 11.68	\$ 35.97
			-2%	0%

**Cox Cable Rates in Cox Systems Facing Competition
From Wireline Overbuilders**

January 1, 2003		Cox Pricing		
Overbuilder	City	State	Basic only Tier	Highest Priced Tier that includes all non premium, non digital channels
Newhouse	Bakersfield	CA	\$ 18.75	\$ 40.25
Sun Tel/CommSouth	Houston County	GA	\$ 10.78	\$ 36.65
Watson Cable	Warner Robins	GA	\$ 10.78	\$ 36.65
Watson Cable	Centerville	GA	\$ 10.78	\$ 36.65
Suburban Cable	Macon	GA	\$ 10.78	\$ 36.65
Suburban Cable	Bibb County	GA	\$ 10.78	\$ 36.65
Brighthouse	Ocala	FL	\$ 12.10	\$ 36.95
Grande Comm.	Midland	TX	\$ 12.05	\$ 37.73
Grande Comm.	Leander	TX	\$ 9.59	\$ 26.25
Grande Comm.	Pflugerville	TX	\$ 9.59	\$ 26.25
CableAmerica	Mesa	AZ	\$ 13.95	\$ 37.95
Qwest	Gilbert	AZ	\$ 13.95	\$ 37.95
Qwest	Scottsdale	AZ	\$ 13.95	\$ 37.95
Qwest	Phoenix	AZ	\$ 13.95	\$ 37.95
Qwest	Peoria	AZ	\$ 13.95	\$ 37.95
Qwest	Chandler	AZ	\$ 13.95	\$ 37.95
Qwest	Glendale	AZ	\$ 13.95	\$ 37.95
Qwest	Maricopa Co	AZ	\$ 13.95	\$ 37.95
Qwest	Paradise Valley	AZ	\$ 13.95	\$ 37.95
Ultronics	Chula Vista	CA	\$ 12.00	\$ 37.90
Ultronics	National City	CA	\$ 12.00	\$ 37.90
Time Warner	San Diego	CA	\$ 12.00	\$ 37.90
Time Warner	Poway	CA	\$ 12.00	\$ 37.90
Adelphia	Encinitas	CA	\$ 12.00	\$ 37.90
Adelphia	San Marcos	CA	\$ 12.00	\$ 37.90
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RCN-PEPCO	Stafford	VA	\$ 12.70	\$ 40.40
RCN-PEPCO	Falls Church	VA	\$ 12.70	\$ 40.40
US West	Omaha	NB	\$ 13.50	\$ 37.05
WideOpenWest	Fairview Park	OH	\$ 8.30	\$ 36.75
GET, LLC	Blackwell	OK	\$ 6.88	\$ 19.00
Service One	Placemine	LA	\$ 8.98	\$ 37.25
Average Rates for Cox Systems Facing Wireline Overbuild Competition			\$ 12.04	\$ 36.60
Average Rates for All Cox Systems			\$ 11.95	\$ 37.75
			1%	-3%

**Cox Cable Rates in Cox Systems Facing Competition
From Wireline Overbuilders**

January 1, 2004			Cox Pricing	
Overbuilder	City	State	Basic only Tier	Highest Priced Tier that includes all non premium, non digital channels
Newhouse	Bakersfield	CA	\$ 19.50	\$ 42.00
Sun Tel/CommSouth	Houston County	GA	\$ 12.00	\$ 39.40
Watson Cable	Warner Robins	GA	\$ 12.00	\$ 39.40
Watson Cable	Centerville	GA	\$ 12.00	\$ 39.40
Suburban Cable	Macon	GA	\$ 12.00	\$ 39.40
Suburban Cable	Bibb County	GA	\$ 12.00	\$ 39.40
Brighthouse	Ocala	FL	\$ 11.10	\$ 38.30
Grande Comm.	Midland	TX	\$ 12.05	\$ 37.73
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US West	Omaha	NB	\$ 14.00	\$ 38.15
WideOpenWest	Fairview Park	OH	\$ 8.30	\$ 39.25
GET, LLC	Blackwell	OK	\$ 6.88	\$ 19.00
Service One	Plaquemine	LA	\$ 8.98	\$ 41.49
Average Rates for Cox Systems Facing Wireline Overbuild Competition			\$ 12.78	\$ 37.84
Average Rates for All Cox Systems			\$ 12.17	\$ 39.03
			5%	-3%

CABLE PROGRAM TIERING: A DECISION BEST AND PROPERLY MADE BY CABLE SYSTEM OPERATORS, NOT GOVERNMENT REGULATORS

November 10, 2003 by William P. Rogerson,* Professor of Economics, Northwestern University

1. Introduction

At the moment, most cable TV systems include sports programming such as ESPN and many regional sports networks (RSNs) as part of the expanded basic tier of programming for which subscribers pay a single monthly fee. The decision of which tier to place this programming in is not regulated by government, *i.e.*, it would be perfectly legal for cable systems-if they were able to negotiate contracts with programmers that permitted this-to offer sports programming (or almost any other type of programming for that matter) on a separate program tier for which subscribers were charged an additional price.

*This Study was prepared for and funded by Cox Communications Inc.

An issue that has received attention from policy makers, industry participants, and the press in the last year is that the license fees that cable systems pay for certain sports programming have been increasing considerably faster than the license fees they pay for non-sports programming, so that the cost of sports programming has begun to consume a very significant and ever-growing share of total programming cost. For example, at a recent investor's conference, James Robbins, the CEO of Cox, reported that it pays \$2.61 per subscriber per month for ESPN, which is more than the cost of the seven top-rated non-sports ad-supported networks combined. He also reported that ESPN was asking for a 20 percent annual increase in its fees from Cox while Fox Sports has proposed a 35 percent increase next year.¹ In its recent report on prices in the cable TV industry the GAO concluded:

"Almost all of the cable operators we interviewed cited sports programming as a major contributor to higher programming costs. On the basis of our analysis of Kagan World Media data, the average license fees for a cable network that shows almost exclusively sports-related programming increased by 59 percent in the 3 years between 1999 and 2002. Conversely, for the 72 nonsports networks, the average increase in license fees for the same period was approximately 26 percent. Further, the average license fees for the sports networks were substantially higher than the average for other networks."²

The increasing expense of sports programming has raised the issue of whether or not it might be desirable for cable systems to offer certain high priced sports programming either as individual channels (this is often referred to as offering the channels "ala carte") or as part of a separate program tier consisting perhaps of a small number of sports channels.³ Rationales for this suggestion include both the idea that it may not be fair or economically sensible to "force" viewers who are not interested in sports to pay for this high-priced programming, and the idea that producers of sports programming might somehow be induced to keep prices lower if their products were offered on a separate tier.

This has, in turn raised two different public policy issues.

Issue #1: Should government require cable systems to offer certain sports channels on a different tier of service than the expanded basic tier?

Issue #2: Should government prohibit cable systems from offering certain sports channels on a different tier of service than the expanded basic tier?

The reason that the first issue has arisen is of course obvious. If it is the case that consumers would be better off if these channels were offered on a separate tier and if it is the case that this outcome will never occur so long as cable systems are not required to do so, then a case for requiring cable systems to do this could be made. Senator John McCain, the Chairman of the Senate Commerce Committee, has raised this issue in recent committee hearings when he stated:

"While not the only cause of cable rate increases, soaring sports programming costs passed along to all expanded basic cable subscribers certainly appear to play a role. I fail to understand why any customer should be forced to pay for programming they do not want. I look forward to hearing the thoughts of our witnesses on the merits of *a la carte* pricing or tiering of cable channels to give consumers more control over their cable bill."⁴

He also asked the GAO to produce a report on pricing in the cable TV industry and one of the issues he specifically asked it to address in its report was the issue of why cable operators group networks into tiers, rather than package networks so that customers can purchase only those networks they wish to receive."⁵

The reason that the second issue has arisen is perhaps not quite so obvious. In response to rising sports programming license fees, some cable systems have begun to consider whether or not it would make sense for them to place certain sports channels on separate tiers of service which subscribers would pay extra for. Pro-

¹New York Times, "Sports Fan is the Prize, of the Victim in Cable Fight," October 6, 2003, page C1 and C4.

²See GAO, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GAO-04-8, October 2003 at 22, ("GAO Study").

³Offering sports channels a la carte or as part of a small tier of sports channels would probably have much the same effect and I will not distinguish between these two alternatives in this paper. To ease the exposition I will generally use the term "offer programming on a separate tier" to refer either to offering the programming a la carte or offering it as part of a group of channels outside of the expanded basic tier for an extra fee.

⁴See *Statement of Senator John McCain, Chairman, Senate Committee on Commerce, Science, and Transportation, Full Committee Hearing on Media Ownership: Video Services*, May 6, 2003.

⁵See GAO Study, October 2003 at 1.

ducers of sports programming have generally reacted quite negatively to this idea.⁶ Besides indicating that they would resist such proposals in any negotiations between themselves and cable systems, some programmers have also made the point that they believe that consumers would be harmed if cable systems were able to negotiate such agreements with programmers. If it is true that consumers would be harmed if cable systems offered sports programming on a separate tier of service, and if it is true that cable systems are seriously considering doing this, then a case could be made for prohibiting cable systems from offering sports programming on separate tiers of service. This is why the second issue has arisen.

One particular programmer that has made arguments along this line is ESPN. ESPN has publically distributed a study by Economists Inc. entitled "Consumer, Operator, and Programmer Benefits from Bundling Cable Networks"⁷ that argues that bundling packages of networks together can in many cases be efficient and benefit both consumers and firms. A sheet of talking points that ESPN has distributed along with this paper states "A-la-carte would be bad for consumers—People will pay more and get less."⁸ Undoubtedly one of ESPN's main goals in making these arguments is to dissuade policy makers from adopting regulations that would require cable systems to offer ESPN on a separate tier of service. However, ESPN also appears to be suggesting that policy makers should consider prohibiting or at least strongly discouraging cable systems from offering ESPN on a separate tier of service in the event that they want to do this.

Cox Communications has asked me to provide my own economic analysis of the issue of whether or not it would ever make sense for policy makers to prohibit or at least strongly discourage cable systems from offering certain high priced sports networks such as ESPN on separate tiers of service, and, in particular, to specifically consider whether the Economists Inc. study distributed by ESPN provides any compelling evidence or arguments in support of this proposition.

My conclusion is that it would be a bad policy for government to either prohibit or discourage a cable system from offering programming on a different tier of service than expanded basic if the cable system determined that this was a good business strategy and was able to negotiate an agreement with the producer of the programming which permitted this. I base this conclusion on four points. First, standard economic theory provides a compelling argument that government's current policy of not regulating the tiering structure of programming is the most desirable policy. Standard economic theory suggests that some bundling and tiering of programming is likely to be efficient, that the precise form of the efficient tiering scheme is likely to depend in complex ways on market conditions that cable systems will understand much better than regulators, and that cable systems will generally have an incentive to choose efficient tiering schemes because cable systems can charge subscribers higher prices by providing them with packages of services that they value more highly.

Second, a well accepted and standard business practice for most cable systems is to offer high cost special interest programming on separate tiers of service instead of including them in expanded basic. For example, almost all cable systems offer premium movie channels and certain premium sports packages on separate tiers of service. The common sense reason for this is simply that when the cost of any particular special interest programming grows too high, the transactions costs of separately selling subscriptions to the program are outweighed by the difficulties that are caused by forcing people to buy an expensive product they may not want. The fact that cable systems have become interested in offering certain sports channels on separate tiers as their costs have skyrocketed is therefore completely consistent with normal well-accepted business practices in this industry that make good economic sense.

My third point is that I do not believe that the Economists Inc. study distributed by ESPN provides any specific arguments or evidence to suggest that government should prohibit a cable system from offering a sports channel on a separate tier if the cable system wanted to and was able to negotiate an agreement with a pro-

⁶See for example *New York Times*, "Sports Fan is the Prize, or the Victim in Cable Fight," October 6, 2003, pages C1 and C4. It describes ESPN's and News Corp.'s reaction to the suggestion of James Robbins, the CEO of Cox, that one solution to rising sports fees might be to offer some sports programming on separate tiers of service. It quoted Peter Chemin, President and Chief Operating Officer of News Corp. which produces many regional sports networks as stating that the idea of tiering was "a nonstarter." Robert Alger, President and Chief Operating Officer of Disney, which owns ESPN, was quoted as describing Mr. Robbins' comments as "comic relief."

⁷Economists Inc., *Consumer, Operator, and Programmer Benefits from Bundling Cable Networks*, July 2002, ("Economists Inc. Study").

⁸Undated sheet entitled "ESPN Key Points" which was attached to copies of the *Economists Inc. (2002)* study distributed to members of Congress and their staffs.

grammer that permitted this. The thrust of the paper by Economists Inc. is to argue that government should not require cable systems to offer sports programming on a separate tier because they believe that cable systems will generally have the incentive to choose an efficient tiering structure. Nowhere in their paper do they attempt to explicitly argue that it would be a good policy for government to prohibit or discourage a cable system from offering sports programming on a separate tier of service if the cable system wanted to do this. This would, in fact, be inconsistent with their central point which is that cable systems ought to have a reasonably good incentive to choose the efficient tiering structure.

My fourth point is that an economic analysis of the nature of the bargaining problem between programmers and cable systems suggests that cable systems might be able to provide programmers with better incentives to keep programming prices low by placing their programming on a separate tier of service instead of bundling it together with large numbers of other programs. One incentive for a programmer to keep its license fees low is created by the fact that cable systems will pass through some of these license fee increases to subscribers in the form of higher subscription prices and this will therefore reduce demand for the programmer's product. It is straightforward to show using standard economic theory that this pass-through effect is muted when a program is bundled together with many other programs. Therefore, to some extent, cable systems may be able provide sports programmers with more powerful incentives to keep their programming costs lower by placing their products in a separate tier and allowing consumers to directly respond to price increases by not purchasing the programming if they wish.

Since the main focus of my paper is on the policy issue of whether or not it would ever make sense for government to prohibit or at least discourage a cable system from placing certain programming on a separate tier if it wanted to do so, I have not focused specifically on the related issue of whether or not it might ever make sense for government to require cable systems to place certain programming on a separate tier even if they wanted to include it in expanded basic. However, it should be clear that the implication of the economic theory I outline above is that it would also generally be a bad idea for government to consider this type of regulatory intervention. Since economic theory suggests that cable systems should have a relatively good incentive to bundle and package programming into tiers in ways that will provide maximum value to their customers, there is in general no "market failure" that requires government intervention. Therefore I believe that government's current policy of essentially not regulating most program tiering decisions of cable systems is generally the correct policy.

My paper is organized as follows. I provide some general background information on program tiering in Section 2. Then I explain each of the four points I list above in Sections 3–6. Finally I draw a brief conclusion in Section 7.

2. Background

Cable TV systems typically offer subscribers access to a group of approximately 60 channels of programming often referred to as the expanded basic programming tier for a single monthly fee. This group of channels is divided into the basic service tier (BST) which consists of primarily local broadcast stations and the major cable program service tier (CPST) which consists of the remaining channels. Cable TV systems are required by regulation to sell subscriptions to the BST without requiring subscribers to purchase any other channels.⁹ With this one exception mandated by regulation, subscriptions to subgroups of channels or individual channels within the expanded basic tier are not sold separately. Rather, to subscribe to any channel or subgroup of channels within the expanded basic tier, consumers must subscribe to the entire tier. Subscribers generally can also purchase access to various additional channels for extra fees. Often many of the additional channels are also packaged into tiers instead of being made individually available. However, some channels of programming that are unusually expensive such as premium movie channels or certain premium sports channels are sold individually.

Except for the requirement that cable systems offer access to the BST, the way that cable TV firms design their various tiers of programming is largely unregulated.¹⁰ That is, cable systems are basically free to decide which tier of service to place any channel in, so long as they are able to negotiate contracts with program-

⁹The price of the BST is subject to regulation unless the cable system faces competition from another wireline provider of video services. The FCC reports that such competition currently exists in only 2 percent of cable markets. See FCC, *In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming: Ninth Annual Report*, MB Docket No. 02–145, December 31, 2002 at para. 115.

¹⁰One additional requirement is that the cable system must require consumers to subscribe to the BST in order to subscribe to any other channels.

mers that permit this. Government essentially does not interfere with whatever arrangements cable systems and programmers are able to negotiate with one another for the tiering of programs.

In this paper I will use the terms “offer programming on a separate tier” or “unbundle programming” synonymously to mean offering programming either by itself or as part of larger package of programs for a separate fee over and above the fee paid for access to the expanded basic tier.

3. The Economics of Whether Or Not Government Should Regulate the Program Tier Structure of Cable Systems

A. The General Argument

The current “hands off” regulatory policy is consistent with and supported by basic economic theory. The relevant economic theory can be summed up in three principles. First, it is likely that some bundling is efficient. While it is true that bundling can harm consumers by reducing their choice, it can also benefit consumers if there are extra transactions marketing and equipment costs associated with selling each channel separately that can be avoided by bundling.¹¹ Second, determining the efficient pattern of bundling will generally be a complex issue which depends on difficult to determine market information such as consumer preferences and the technology of production. In most cases, firms in the industry will be much better informed about these sorts of factors than government regulators.¹² Third, it seems likely that profit maximizing firms will generally have an incentive to bundle products efficiently. This is simply because they can charge consumers more money by providing them with packages of products that better fill their needs. Since firms will be generally be much better able to determine what sorts of bundling arrangements might produce efficiencies and since they will generally have an incentive to adopt efficient bundling arrangements, it therefore makes sense to delegate this decision to firms.

B. Regulation of Bundling and Monopoly Power

Except for the BST, government essentially does not regulate the prices that cable systems charge to subscribers. It is probably fair to say that there is a fairly wide range of views among economists, policy makers, consumer activists, and industry representatives regarding how much market power is possessed by cable systems. Therefore it is interesting ask whether or not and how the economic argument that regulation of bundling is unnecessary is related to the issue of whether or not cable TV systems have market power or not. I will make two basic points in this regard.

First, and most important, the conclusion that there is no general need for government regulation of bundling does not depend critically on the precise level of competition that exists in this industry. This is because even a firm with market power will generally want to supply its customers with their most preferred mix and packaging of products because it will be able to charge consumers the highest possible price by so doing. Therefore, while various groups may disagree on the extent to which cable systems have market power, they should all still be able to agree that there is no good case for extensive regulation of program tiering structure.

Second, and related, the idea that regulation of program tiering could somehow substitute for regulation of market power is simply incorrect. People who believe that cable systems have so much market power that their prices should be regulated should still not be in favor of regulating the program tiering structure of cable systems. If a firm has market power, it will be able to charge high prices for whatever bundles of products that it sells. Allowing government to regulate how firms with market power bundle products will only increase the likelihood that the firms do not offer the most efficient bundle of products, but will not prevent them from charging monopoly prices for whatever bundles of products they do sell.

C. Bundling and Price Discrimination

The above two subsections have presented the argument that, to the extent that bundling is a way to reduce transactions and marketing costs, it is likely that cable systems will have appropriate incentives to correctly balance the costs and benefits of bundling and therefore choose efficient levels of bundling. There is also one other

¹¹ See the *Economists Inc. Study*, July 2002 for a much fuller discussion of the potential benefits of bundling.

¹² For example, in its recent report on cable industry prices, the GAO specifically investigated the issue of whether consumers might be made better off if cable systems were required to unbundle more programming and decided that it could draw no conclusion on this issue. The report states: “Thus, there are a variety of factors that make it difficult to ascertain how many consumers would be made better off and how many would be made worse off under an a la carte approach.” See *GAO Study*, October 2003 at 37.

motivation that firms may have for bundling products together that could possibly apply to the case of cable TV. This motivation for bundling is often referred to as the price discrimination motive since it is related to a firm's motivation to try to charge different consumers different prices for the same product depending upon what they are willing to pay for it.¹³ The essential idea is that when there is some negative correlation between individual consumers' valuation of different products,¹⁴ that a firm can sometimes charge higher prices to everyone by bundling the goods together.

If this is the motivation for bundling, the issue of whether or not firms will always pursue bundling strategies that benefit consumers is somewhat murkier. In particular it is easy to create examples where bundling can make consumers worse off but equally easy to create examples where bundling makes consumers better off.¹⁵ I think a fair characterization of the consensus view of economists at this point is that they simply do not know whether this type of bundling is likely to benefit or harm consumers. However, since regulation is costly and can create other distortions, the fact that this type of bundling cannot be shown to be systematically harmful to consumers is sufficient reason for most economists to conclude that there is no reason to regulate this type of bundling.

This is of course a somewhat weaker conclusion than the one that applies to the case of bundling motivated by reduction of transactions costs. For the case of transactions costs, economic theory suggests that firms will generally have an incentive to engage in bundling that benefits consumers. For the case of price discrimination, economists simply cannot say at this point whether there appears to be any systematic tendency for such bundling to make consumers better off or worse off.

However, economic theory still does not suggest a general need for regulation of bundling in this case. Furthermore, it is not clear to what extent the motivation of price discrimination applies to the bundling decisions in cable TV. Therefore, consideration of this alternate motivation for bundling does not appreciably change my conclusion that government is unlikely to be able to make consumers better off by regulating the way that cable systems bundle programming together.

4. Cable Systems Generally Follow the Practice of Unbundling Special Interest High Cost Programming

A common sense proposition supported by real world behavior is that, when programming is only of interest to a minority of viewers and is extremely costly, that it should be offered at a separate price rather than included in the expanded basic bundle. This is because the cable system needs to charge a fairly high price to recover the costs of the programming but only a fraction of the population would be willing to pay such a high price. The cable system would risk losing too many general viewers with no interest in the costly programming if it included it in the expanded basic package and tried to raise prices enough to cover the cost. In such a case it makes more sense for the firm to charge a separate high price for the programming and only sell it to people willing to pay this high price.

Cable systems appear to already follow this general principle and I believe that policy makers and the public already accept its common sense. In particular the most costly programming that most cable systems show are the premium movie channels, pay per view channels, and premium sports packages and all of these are generally sold separately instead of being included in the expanded basic tier. The fact that cable systems have begun to express an interest in moving certain sports programming out of the expanded basic tier as the costs of this programming have begun to skyrocket strikes me as being completely consistent with the general practice that cable firms have always followed to place unusually expensive special interest programming on separate tiers of service instead of including it in expanded basic.

¹³ See William James Adams and Janet L. Yellen, "Commodity Bundling and the Burden of Monopoly," *The Quarterly Journal of Economics*, August 1976, 90, 475-498; Richard Schmalensee, "Gaussian Demand and Commodity Bundling," *The Journal of Business*, January 1984, 57, S211-S230; R. Preston McAfee, John McMillan and Michael D. Whinston, "Multi-product Monopoly, Commodity Bundling, and Correlation of Values," *The Quarterly Journal of Economics*, May 1989, 104, 371-383; and Gregory Crawford, "The Discriminatory Incentives to Bundle: The Case of Cable Television," October 7, 2002, unpublished manuscript, Duke University.

¹⁴ For example this would be true if on average a viewer with a high willingness to pay for sports programming has a low willingness to pay for nonsports programming and a viewer with a high willingness to pay for non sports programming has a low willingness to pay for sports programming.

¹⁵ The Economists Inc. study provides an example in its appendix where bundling is profitable and consumers are made better off by bundling. See Adams and Yellen (1984), Figure 4 at 482 for an example where bundling is profitable and consumers are made worse off by bundling.

5. The Economist Inc. Study Does Not Provide Any Support for the Proposition That Government Should Prohibit Cable Systems from Offering Sports Programming on a Separate Tier of Service

A careful reading of the study that ESPN has distributed by Economists Inc. reveals that the study provides no specific arguments or evidence in support of the proposition that government could help consumers by forcing cable systems to offer certain programming such as ESPN on expanded basic when the cable systems would rather offer it on a separate tier. This is not a question that the paper even raises, much less answers. Rather, the sole focus of the paper is to support the proposition that government should not force cable systems to offer certain programming such as ESPN on a separate tier of service if the cable systems would rather offer it as part of expanded basic.

The Economists Inc. study makes two basic economic points to support its position. These are that:

- (i) there are good economic reasons to believe that some amount of bundling of programming is likely to be efficient
- (ii) when cable systems find it profitable to bundle this will also generally benefit consumers.

However, the Economists Inc. study does NOT attempt to argue that circumstances exist where a cable system might find it profitable to place programming on a separate tier but consumers would be better off if the cable system was forced to offer it as part of the expanded basic tier. The example in the Appendix to the Economists Inc. study is an example where the cable system finds it profitable to bundle and consumers are also made better off by this. It is NOT an example where the firm finds it profitable to unbundle but consumers would be made better off if the cable system was forced to bundle.

In my opinion arguments (i) and (ii) made by the Economists Inc. study in support of the proposition that government should not require unbundling are simply part of the standard view of the economics profession on the economics of bundling that private firms will generally have an incentive to bundle to the extent this is efficient and there is therefore no need for extensive government regulation. In particular, while this conventional view supports the proposition that there is no need for mandatory unbundling, it also supports the proposition that there is no need for mandatory bundling either. Therefore although the Economists Inc. study did not explicitly address the issue of mandatory bundling, the arguments they have made would generally be consistent with the view that there is no need for mandatory bundling.

6. Unbundling May Help Reduce Program Costs

Until this point in the paper I have implicitly taken the view that program costs are exogenously determined and the only question of interest is how a cable firm should arrange its program tiers given the exogenously determined program costs. However, I believe that this viewpoint does not take into account one of the benefits that consumers may receive when programming is placed in a separate tier. Namely, placing programming in a separate tier may actually reduce the incentives for programmers to attempt to negotiate higher prices with cable systems and therefore also decrease programming costs. At least a share of these cost savings would likely be passed on to consumers and this would provide an extra benefit to consumers.

When a sports programmer considers asking for a price increase, one factor that the programmer considers is that, to some extent, the cable system will pass through some of this increase to subscribers in the form of higher subscription prices and that this will, in turn, reduce demand for the programmer's product. That is, cable system pass-through of programming price increases is a factor which provides the programmer with a stronger incentive to keep its prices lower. It is straightforward to show using completely standard economic models, that the pass through effect for a program will be larger if the program is offered separately at its own price rather than as part of a large package of programs at a single price. The result is that a programmer will charge a lower price for programming if his program is offered on a separate tier than if it is bundled together with other programs. I provide a simple example in an appendix to this paper which illustrates this point. In the example, the cable system finds it profitable to unbundle programs because this induces programmers to lower their license fees. Furthermore, consumers also benefit from unbundling because this results in lower subscription prices.

This idea is very intuitive. When a program is offered to consumers as part of a large package, the effect of price changes of any particular program on subscriber demand for the package will be muted and this reduces the incentive of individual programmers to keep prices low. When a program is placed on a separate tier, a

programmer experiences a much larger and direct loss of demand when it raises its prices and this provides the programmer with a large and immediate incentive to keep prices lower.

7. Conclusion

Economic theory suggests that government's current policy of not extensively regulating the program tier structure of cable TV systems is a sensible policy. In particular, it is unlikely that consumers would benefit if government prohibited a cable system from offering certain costly sports programming such as ESPN on a separate tier of service if the cable system wished to do this and was able to negotiate an agreement with a programmer which permitted it.

APPENDIX

Introduction

The purpose of this appendix is to present a simple example which illustrates the idea that a downstream cable system can provide stronger incentives for upstream programmers to charge lower license fees by offering programs on separate tiers instead of bundling them together.

The Example

I will assume that there are two programmers called programmer 1 and programmer 2 that each sell a different program to a single cable system which in turn sells subscriptions to consumers. I will assume that the inverse demand curve of subscribers for each program is the same and is given by

$$(1) p_i = A - B q_i$$

where p_i denotes the price of a subscription to program i , q_i denotes the quantity of subscriptions to program i sold, and A and B are positive constants. I will also assume that any given consumer has the same willingness to pay for each program.¹⁶ This means that the inverse demand curve for the bundle of both products is simply the vertical sum of the two inverse demand curves for each program and is given by

$$(2) p_b = 2A - 2Bq_b$$

where p_b denotes the price of a subscription to the bundle of both programs and q_b denotes the number of subscriptions sold. Finally I will assume that all costs of production are zero.

The pricing game occurs in two stages. At the first stage each programmer chooses a license fee that it charges the cable system for its program. Let w_i be the per subscriber license fee that programmer i charges. Then at stage 2, the cable system chooses its retail price or prices. I will solve this game both for the case where the programs are sold as a bundle for a single price p_b and where the programs are sold for separate prices, p_1 and p_2 .

The Case of No Bundling

First suppose that the cable system sells each program separately. As usual, the equilibrium of a two stage game is solved by working backwards. When the programs are sold separately, the cable system plays a separate identical game with each programmer. Begin by considering the cable system's behavior at stage 2 if the license fee w_i has been set for program i at the first stage. The cable system is a monopolist facing the linear demand curve given by (1) with costs w_i . It is straightforward to calculate that it chooses the price and quantity given by

$$(3) p_i = (A + w_i)/2$$

$$(4) q_i = (A - w_i)/2B.$$

Now consider programmer i 's decision at stage 1. Programmer i is a monopolist with demand curve given by (4) and zero costs. It is straightforward to calculate that it chooses a license fee equal to

¹⁶That is, I assume that consumers who are willing to pay a high amount for one program are also willing to pay a high amount for the other program. In fact, I make the extreme assumption that the willingness to pay for programs is perfectly correlated in the sense that each consumer has the same willingness to pay for each program. This assumption implies that there is no price discrimination motive for bundling and therefore considerably simplifies the analysis. The same incentive effect as identified in this example would exist in more complex cases where there is also a price discrimination motive for bundling but the analysis would be considerably more complicated.

$$(5) w_i = A/2.$$

Substitution of (5) into (3) yields

$$(6) p_i = 3A/4.$$

Therefore the sum of program fees is given by

$$(7) p_1 + p_2 = 3A/2.$$

Therefore each programmer chooses a license fee of $A/2$ and the cable system charges a price of $3A/4$ for each program. Consumers purchasing both programs pay a price of $3A/2$.

The Case of Bundling

Now suppose that the cable system bundles the two programs together. Once again, begin by considering the cable system's behavior at stage 2 if prices of w_1 and w_2 have been set at stage 1. The cable system is a monopolist facing the linear demand curve in (2) with costs given by $w_1 + w_2$. It is straightforward to calculate that the price and quantity chosen by the cable system are given by

$$(7) p_b = (2A + w_1 + w_2)/2.$$

$$(8) q_b = (2A - w_1 - w_2)/B.$$

Now consider the first stage. At the first stage we solve for a Nash equilibrium in license fees given that the each programmer faces the demand curve given by (8) at the second stage. It is straightforward to calculate that the Nash equilibrium has each programmer charge the license fee

$$(9) w_i = 2A/3.$$

Substitution of (9) into (7) yields

$$(10) p_b = 5A/3.$$

Therefore each programmer charges a price of $2A/3$ and the price of the bundle of the programs is $5A/3$.

Conclusion

By comparing the two solutions, it is clear that license fees and retail prices are both lower when the programs are unbundled. Furthermore it is also straightforward to check that the cable system earns higher profits when the programs are unbundled. Therefore the cable system would prefer to offer each program separately and, furthermore, this makes consumers better off. This is because the upstream programmers are induced to charge lower license fees when the programs are unbundled.

CORRECTING THE ERRORS IN THE ESPN/CAP ANALYSIS STUDY ON PROGRAMMING COST INCREASES

November 11, 2003 by Professor William P. Rogerson,* Professor of Economics, Northwestern University

1. Introduction

Since the deregulation of all but limited basic cable TV prices in 1996, Congress and the FCC have both closely monitored the performance of the cable TV industry. A chief focus of concern has been measuring the extent to which the prices that consumers pay for subscriptions to cable TV have risen and whether or not these price rises can be explained by increases in the costs of providing cable television. One particular issue that has arisen is the extent to which price rises simply reflect rising programming costs. In particular, cable TV firms have argued that a substantial share of the price increases that consumers have experienced simply reflects a pass-through of increases in the license fees that cable TV firms are charged by producers of programming for the right to show the programming to their subscribers. Programmers, on the other hand, have argued that increases in license fees constitute a relatively minor share of the total cost increases in the cable industry, and that the blame lies elsewhere.

Perhaps surprisingly, no straightforward answer has been forthcoming to this simple question. For years, as part of its survey of cable TV prices, the FCC has asked cable TV firms to provide their own estimate of how big an effect programming price increases have had on the prices that they charge subscribers, and has

*This study was prepared for and funded by Cox Communications Inc.

reported the average response as part of its annual survey of cable prices.¹ However, it has not been clear how to interpret these estimates since firms are given no explicit formula for calculating the effect. In a recent report on cable TV prices, the GAO gathered, reviewed and presented various cost and price data as part of its analysis and provided the qualitative conclusion that “programming expenses and infrastructure investment appear to be the primary cost factors that have been increasing in recent years.”² It did not, however, provide any specific numerical estimate of the share of price increases that can be explained by programming increases. A recent ESPN sponsored study³ by Cap Analysis used publically available data to estimate cost increases for the cable industry over the period from 1999 to 2002 for all categories of costs and calculated that cost increases due to increases in programming costs constituted 20 percent of the total cost increases that had occurred over this period. It argued that this was a relatively small share and that increases in programming costs therefore did not play a major role in explaining increases in cable subscription prices relative to other cost factors.

The very simple point that I make in this short paper is that there is a straightforward calculation that the ESPN/Cap Analysis study could have performed with data on subscription prices and programming costs that would have provided much more illuminating and economically meaningful information about the extent to which price increases in cable TV subscription prices can be explained by increases in the licensing fees for programming. Namely, given data on estimated programming cost increases, it is straightforward to calculate the amount that cable TV subscription prices would have had to rise in order to just recover the estimated increases in programming costs. The actual amount that subscription prices for cable TV rose can be calculated from FCC data. Dividing the amount that subscription prices would have had to rise in order to just cover increased programming costs by the actual amount that subscription prices rose provides a natural measure of the share of price increases that can be attributed to rising program costs.

Note that the amount that subscription prices would have had to rise in order to cover increased programming costs is not necessarily exactly the same value as the amount that subscription prices actually did rise because of increases in programming costs.⁴ This is because a profit maximizing firm facing a downward sloping demand curve may generally find it optimal to pass through only a portion of program cost increases. Nonetheless, for the practical purpose of assessing the performance of the cable industry, I think that policy makers’ main interest is in simply determining whether or not prices have been rising faster than they would have had to rise in order to cover all cost increases and the approach I suggest is the correct one to analyze this question.

Using FCC data, I calculate that between 1999 and 2002 the price of expanded basic cable TV service increased by \$7.06 per subscriber per month.⁵ Based on estimated program cost data from the ESPN sponsored study, I calculate that during this same time period the net cost⁶ of expanded basic programming increased by \$2.96 per subscriber per month. Therefore based on this data, 42 percent of the increases in expanded basic cable TV prices over this period were necessary to cover the increased cost of programming—a percentage roughly twice the figure posited in the ESPN/Cap Analysis study. This supports cable firms’ claims that a significant share of increases in the subscription prices for expanded basic cable TV in recent years can be attributed to rising programming costs over this same period.

The remainder of this paper is organized as follows. In Section 2 I present the calculation of the amount that subscription prices would have had to increase in order to just cover the increased cost of programming. I then compare this value

¹For the most recent such report, see *In the Matter of Section 3 of the Cable Television Consumer Protection Act of 1992, Docket 92-266, Report on Cable Industry Prices*, July 8, 2003 at 13, (“FCC Report on Cable Industry Prices”).

²See GAO, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, GA0-04-8, October 2003 at 12–15, (“GAO Report”).

³Jeffrey A. Eisenach and Douglas A. Trueheart, CAP Analysis, *Rising Cable TV Rates: Are Programming Costs the Villain?* October 23, 2003, (“ESPN/Cap Analysis Study”).

⁴That is, one could conduct the thought experiment of asking what the subscription price for cable TV would have been if program costs had remained constant. The difference between the actual subscription price and this hypothetical subscription price could be interpreted as the amount that prices actually rose because of program cost increases.

⁵As will be described in more detail below, prices and costs are calculated for what is often called the expanded basic tier of programming which typically contains about 60 channels including local broadcast channels and most major advertiser supported cable networks delivered on an analog system.

⁶As will be described below, the cost of program license fees is to some extent offset by income earned from advertising and the appropriate measure of the cost of license fees to use is license fees net of income earned from advertising.

to the actual amount by which prices rose. In Section 3 I briefly explain why it would be difficult to extend the method I have used here to the case of other input costs. In Section 4 I explain why the calculation the ESPN/Cap Analysis study performed does not provide meaningful information on the extent to which subscription price rises for cable TV can be explained by increases in programming costs. Finally, I draw a brief conclusion in Section 5.

2. Calculation of the Subscription Price Increase Necessary to Cover Increased Programming Costs

Cable systems typically offer subscribers access to a group of approximately 60 channels over an analog system which includes local broadcast stations plus the most popular advertiser supported cable networks for a single monthly fee. This group of channels is sometimes called the expanded basic service tier and is the most commonly purchased service tier in most cable systems.⁷ Subscribers generally can also purchase access to various premium channels and pay per view channels for additional fees. For the purposes of this paper I will focus on the expanded basic service tier.

Using FCC data on cable TV prices charged to subscribers, I calculate that the average monthly price that subscribers have paid for an expanded basic subscription increased from a value of \$29.41 in 1999⁸ to a value of \$36.47 in 2002⁹ (which is the most recent year for which data is available.) Therefore the price of cable service increased by \$7.06 over this period.¹⁰

I will now turn to calculating the amount by which prices would have had to increase in order to cover the increase in operators' programming costs over that same time period. Cable systems typically earn some revenue from selling advertising time on the programs they show. Of course they also incur some costs selling this advertising, but the net revenues they earn from selling advertising are generally positive and therefore offset part of the cost of purchasing programming. To account for this fact, I will calculate the increase in net programming costs instead of the increase in gross programming costs where net programming costs are defined as

$$\text{Net Programming Cost} = \text{Gross Programming Cost} - \text{Net Advertising Revenue}$$

and net advertising revenue is defined as

$$\text{Net Advertising Revenue} = \text{Gross Advertising Revenue} - \text{Cost of Selling Advertising.}$$

The ESPN sponsored study reports that over the period from 1999 to 2002, the estimated license fees that cable systems paid for expanded basic programming increased from \$6.70 per subscriber per month to \$10.20 per subscriber per month¹¹ for a change of \$3.50 per subscriber per month. Using the terminology described above, these are the gross programming costs, so \$3.50 is the change in gross programming costs. Unfortunately, neither the ESPN sponsored study nor any other publically available source that I am aware of presents data on net advertising revenues for the expanded basic tier. Using data provided by the GAO and Cox Communications, I estimate that net programming costs are equal to approximately 84.5 percent of gross programming costs, *i.e.*, that net advertising revenue offsets ap-

⁷ This group of channels is divided into the basic service tier (BST) which consists primarily of local broadcast stations and the major cable programming service tier (CPST) which consists of the remaining stations. Access to the BST can be purchased separately but the vast majority of subscribers purchase both the BST and the major CPST.

⁸ See *FCC Report on Cable Industry Prices*, February 14, 2001. The data reported for 1999 separately reports the price for systems facing effective competition and for systems not facing effective competition but does not report a weighted average price for both groups. The average price for systems facing effective competition was \$27.78 and the average price for systems not facing effective competition was \$29.52. I calculated a weighted average price using the weight of 6.1 percent for the group facing effective competition and a weight of 93.9 percent for the group not facing effective competition, which were the weights the FCC began to use the following year when it first calculated the weighted average price. See *FCC Report on Cable Industry Prices*, April 4, 2002, at note 22, page 7.

⁹ See *FCC Report on Cable Industry Prices*, July 8, 2003 at 9.

¹⁰ The prices reported above are for programming and do not include the price of equipment (converter and remote) which is reported separately. Since consumers do not need this equipment to subscribe to expanded basic and since such equipment is available for sale from third parties in any event, equipment prices should be unrelated to programming costs. The GAO (*GAO Report*, October 2003) follows the same procedure in its recent report on cable industry prices, *i.e.*, when it reports FCC data on subscription prices it does not include the equipment charge.

¹¹ See *ESPN Study*, October 23, 2003, Figure Four at 11.

proximately 15.5 percent of programming costs.¹² As described above, the ESPN study reports that the change in gross program costs was \$3.50. Therefore the change in net program costs is 84.5 percent of this value or \$2.96.¹³

In conclusion, over the period 1999 to 2002, FCC data demonstrate that actual subscription prices for cable TV rose by \$7.06. During this same period, using the cost estimates set forth in the ESPN/Cap Analysis study, the net cost of this programming rose by \$2.96. Therefore 42 percent of the actual rise in subscription prices for cable TV can be explained by the rise in programming costs in the sense that this is the amount prices would have had to rise in order for cable systems to recover their increased programming costs. This figure is twice as large as the percentage of increased programming costs to total increased costs calculated in the ESPN/Cap Analysis study.

3. Problems With Applying This Method to Other Classes of Input Costs

A natural “next question” to consider given the above results, would be to examine cost increases of other inputs. In an ideal world one would be able to determine the increases in the costs of all inputs, calculate the subscription price rise that would have been necessary to cover these cost increases, then compare this value to the actual value of price increases to assess the performance of the industry, and, in particular, to determine whether or not price rises have simply covered increased costs or contributed to increased profits. The problem with pursuing this next question is that, while the cost of programming is unambiguously a direct cost of providing expanded basic service, most other categories of costs are much less directly associated with any particular product and instead must be allocated among products. In particular, it seems likely that a relatively large share of increased capital costs and perhaps also a share of increased operating costs may have been incurred in order to permit firms to offer more advanced products than expanded basic service, such as digital tiers of service (including pay per view and video on demand), broadband Internet connections, and telephony.

In my opinion, any attempt to allocate a portion of these cost increases to basic analog service (in order to determine if prices for expanded basic service have risen by more than would have been sufficient to cover all cost increases of expanded basic service) would require a long list of assumptions which would be open to question and controversy. Attempting to construct and defend a set of allocation rules for other costs is a complex undertaking that is beyond the scope of this paper. My point in this paper is that the ESPN/Cap Analysis study could have used a simple, unambiguously correct way of determining how much cable subscription prices would have had to rise to cover increased programming costs because programming costs are a direct cost of providing this service, and I have restricted myself to conducting this calculation.

4. The ESPN/Cap Analysis Study

My conclusion that increased programming costs play an important role in explaining increased subscription prices for cable TV contradicts the conclusion of a recent ESPN sponsored study by Cap Analysis¹⁴ that downplays the significance of

¹²The only information the GAO provides on advertising revenues is that gross advertising revenues offset 31 percent of gross program costs in its sample of firms for 2002 (*GAO Report (2003)* at 25). While the GAO reports that “there are significant costs of selling television ads,” (*GAO Report (2003)* at 25), it unfortunately does not provide any numerical estimate of the size of these costs. I was informed by Cox Communications officials that selling costs of advertising are approximately equal to 50 percent of gross advertising revenues for them. Using this figure and the GAO figure that gross advertising revenues are 31 percent of gross program costs, yields the estimate that net advertising revenues are equal to 15.5 percent of gross program costs.

¹³As a check on the accuracy of this estimate, I used another method to estimate this value as well. The ESPN sponsored study reports the value of gross advertising revenues per subscriber across all tiers of service. These were \$2.48 per subscriber per month in 1999 and \$3.73 per subscriber per month in 2002 for a change of \$1.25 (*ESPN Study* at 15). To apportion these revenues between expanded basic and other tiers I used the figure from the ESPN sponsored study that in 2002 programming costs for expanded basic were 65 percent of total programming costs. If 65 percent of total advertising revenues are earned by expanded basic, then this yields an increase in expanded basic gross advertising revenues of 81 cents. If net revenues are half of gross revenues (as discussed above), then the change in net revenues would be 41 cents. Subtracting this value from the gross programming cost increase of \$3.50 yields a net programming cost increase of 3.09 which is somewhat higher than the estimate of \$2.96 I derived above. Under this alternate estimate, increased programming costs would therefore explain 44 percent of the actual increase in the subscription price of cable TV.

¹⁴Jeffrey A. Eisenach and Douglas A. Trueheart, CAP Analysis, *Rising Cable TV Rates: Are Programming Costs the Villain?* October 23, 2003, (“ESPN/Cap Analysis Study”).

increased program costs relative to other cost increases. Specifically this study concludes:

“ . . . while the costs of producing and acquiring programming are rising for cable networks and cable operators alike, basic cable programming costs account for only about 20 percent of the cost increases faced by cable operators in recent years. Operating costs and capital expenditures are a far more significant source of cost increases than programming.”¹⁵

While I agree with the conclusion of this study that operating costs and capital costs have been increasing for the cable industry and that a share of these cost increases ought to be attributed to expanded basic analog cable service, I completely disagree with the approach the study took to evaluate the relative importance of various classes of cost increases with respect to their effect on expanded basic subscription prices. In my opinion the study makes two fundamental conceptual errors. First, the study treats annual investment expenditures as annual operating expenses instead of amortizing them as any elementary economics textbook would suggest. Second, as discussed above, a major share of the increased capital costs and also a share of the increased operating costs are likely not directly associated with providing basic analog cable service. Rather they are associated with providing digital video service (including pay per view and video on demand), broadband Internet connections, and local telephony. However, the study simply compares aggregate cost increases for the firm as whole. The argument that the increased costs that cable firms have incurred to provide advanced services are large relative to increased programming costs does not diminish the extent to which cable subscription prices have had to rise in order to cover increased programming costs. To put this another way, my calculation that cable subscription prices would have had to rise by \$2.96 per subscriber per month over the period from 1999 to 2002 in order for cable systems to recover their increase in estimated programming costs is a correct calculation independent of how large any other cost increases have been.

5. Conclusion

A simple and natural way to measure the extent to which increases in subscription prices for cable TV can be explained by or attributed to increases in the cost of programming is to calculate the amount that subscription prices would have had to rise in order for cable systems to recover the increased programming costs and then compare this increase to the actual increase. Using industry wide data for the 1999–2002 period, I calculate that 42 percent of the price rises that actually occurred can be explained by or attributed to increases in estimated programming costs. Therefore it appears that increases in programming costs do account for a significant share of the increases in subscription prices for cable TV that have occurred over this time period.

The CHAIRMAN. Thank you very much. Mr. Bodenheimer.

STATEMENT OF GEORGE BODENHEIMER, PRESIDENT, ESPN, INC., AND ABC SPORTS

Mr. BODENHEIMER. Thank you, Mr. Chairman and Members of the Committee. I appreciate the opportunity to speak with you this morning. I am President of both ESPN and ABC Sports. ESPN is the distributor of two of the largest all-sports programming networks, ESPN and ESPN2, as well as ESPN News, a 24-hour sports news channel, and ESPN Classic. We are also driving the digital transition with our high-definition service, ESPN Hi-Def, and we are expanding our reach with the recently launched ESPN Deportes, our 24-hour Spanish language network.

Eighty-five percent of Americans say they are sports fans, and expanded basic cable in particular offers them a fantastic array of sports viewing options. Sports are clearly one of the most important reasons why people subscribe to cable. Therefore, I would like to be very clear on one very important issue. It would be a consumer disaster for Congress to force ESPN and other channels out

¹⁵ *ESPN/Cap Analysis Study*, 2003, at 16–17.

of the expanded basic lineup. Doing so would not address concerns over the retail price of cable or indecency. Instead, consumers will be angry and highly dissatisfied if their favorite sport or college team or conference is taken out of expanded basic and available only to them as a premium service for which they must pay more.

As to indecency, neither à la carte nor the family tier concept would be an effective tool. Existing V-chip and related blocking technology offer better, less intrusive alternatives. Providing a reasonable and uniform decency standard is applicable to all channels on the basic and expanded basic tier.

We were pleased to have cooperated with GAO in its report preparation and we concur with its primary conclusions. First, competition, not regulation, is the most effective way to provide consumers with the best products, the broadest choices, and the best prices.

Second, program costs are not the primary driver of cable prices. It is simply wrong to blame ESPN for the retail price decisions of cable operators. And ESPN's new distribution deals with moderating rate increases respond to concerns that Congress and this committee may have had about the impact of ESPN's rates going forward.

We also agree with GAO that à la carte distribution schemes, whether for all services or just directed at a particular genre, will only produce higher prices for all customers, less choice, and the extinction of many channels that serve specific but important audiences. A la carte would force consumers to pay more for their programming and to rent or buy set-top boxes they don't now need or want. Every television would need such a box to activate à la carte, and at \$3 to \$4 rental per box per month, consumers would be looking at much higher costs for fewer channels.

Today, as you know, less than half of all televisions in America have a set-top box. A la carte would force all channels to expend millions of dollars in marketing and cable providers to spend huge sums on transaction costs to account for the churn brought about by people adding and dropping channels.

These costs would most likely be borne by customers, again in the form of higher, not lower rates. Make no mistake about it. Whether you call it a family tier or à la carte, the consumer would be hit with higher costs and less choice. Cable TV is a tremendous entertainment value, and for a growing and significant number of Americans, satellite is offering a similarly compelling choice for multi-channel video. Indeed, consumers today have a wide array of purchase options, from broadcast basic cable at about \$14 a month to satellite packages starting at \$25 a month to the latest wireless video service that offers popular cable networks and high definition broadcast signals for \$20 per month.

It's clear that choice and competition have taken hold. Government regulation causing the breakup of expanded basic would not serve any positive purpose. Consumers will not be happy or grateful if ESPN and other cable channels are ripped out of basic service so that cable subscribers are charged extra fees to see the programming they enjoy today as part of their basic cable subscription.

Thank you, Mr. Chairman. I look forward to responding to your questions.

[The prepared statement of Mr. Bodenheimer follows:]

PREPARED STATEMENT OF GEORGE BODENHEIMER, PRESIDENT,
ESPN, INC. AND ABC SPORTS

Thank you Mr. Chairman and members of the Committee. I appreciate the opportunity to speak with you this morning. I am President of ESPN and ABC Sports.

ESPN is the distributor of two of the Nation's largest all sports programming networks, ESPN and ESPN2 as well as ESPNEWS, a 24-hour sports news channel, and ESPN Classic. We are also driving the digital transition with ESPN HD and we are expanding our reach with the recently launched ESPN Deportes, our 24-hour Spanish-language network.

ESPN is, of course, not the only network delivering sports programming to consumers. Sports programming is on all four major broadcast networks, many top cable networks and all told more than 30 national and regional cable networks carry major sports properties. Sports programming is extremely popular and the acquisition of sports rights is highly competitive.

If you are a sports fan, and 85 percent of Americans say they are, expanded basic cable in particular offers you a fantastic array of sports viewing options and sports are clearly one of the most important reasons why people subscribe to cable. Therefore, I would like to be very clear on one very important issue: it would be a consumer disaster for Congress to force ESPN and other channels out of the expanded basic lineup. Doing so will not address concerns over the retail price of cable or indecency. Instead, consumers will be angry and highly dissatisfied if their favorite sport or college team or conference is taken out of expanded basic and available only as a premium service for which they must pay more. As to indecency, neither à la carte nor the "family tier" would be an effective tool. Existing v-chip and related blocking technology offer better, less intrusive alternatives provided a reasonable and uniform indecency standard is applicable to all channels on the basic and expanded basic tier.

GAO Report

We were pleased to have cooperated with GAO in its report preparation and we concur with its primary conclusions. First, competition, not regulation, is the most effective way to provide consumers with the best products, the broadest choices and the best prices. Second, programming costs are not the primary driver of cable prices. It is simply wrong to blame ESPN for the retail price decisions of cable operators, and ESPN's new distribution deals with moderating rates respond to concerns Congress or this committee may have had about ESPN's impact going forward.

We agree with GAO that à la carte distribution schemes—whether for all services or just directed at a particular genre—will only produce higher prices for all cable customers, less choice and the extinction of many channels that serve specific but important audiences. A la carte will force consumers to pay more for their programming and to rent or buy set-top boxes they don't need or want. Every television would need such a box to activate à la carte and at \$3 to \$4 rental per box per month, consumers are looking at much higher costs, for fewer channels. Today, as you know, less than half of all televisions in America have a set-top box. A la carte will force all channels to expend millions of dollars in marketing and cable providers to spend huge sums on transaction costs to account for the churn brought upon by people adding and dropping channels. These costs will most likely be borne by customers, again in the form of higher, not lower, rates. Make no mistake about it, whether you call it a "family tier" or à la carte, the consumer will be hit with higher costs and less choice.

Cable and Satellite Value and Choice

Cable TV is a tremendous entertainment value, and for a growing and significant number of Americans, satellite is offering a similarly compelling choice for multi-channel video. Indeed, between the two, it's clear that choice and competition have taken hold. Consider these facts:

- Consumers already can choose to avoid programming they don't want by subscribing to the broadcast basic tier. Some 10 percent of cable subscribers take only this service—over 25 channels in most markets for an industry average cost of about \$14;
- The major satellite providers, DIRECTV and Dish Network, are the fastest growing multi-channel distributors offering packages of 60 or more video channels starting at around \$25 a month;
- An average cable system offers between 60 and 70 channels for about \$40 month and a growing array of other popular service like cable modems for Internet access and high-definition television;

- Just in the past few months a new wireless service called U.S. Digital Television began offering subscribers in several cities a package of local high-definition broadcast signals and 11 of the most popular cable networks, including ESPN and ESPN2, for \$20 a month.

Indeed, consumers' today have a wide array of purchase options and competition is here and growing. Government regulation causing the breakup of expanded basic would not serve any positive purpose. Consumers will not be happy—or grateful—if ESPN and other cable channels are ripped out of basic service so that cable subscribers are charged extra fees to see the programming they enjoy today as part of their basic cable subscription.

Thank you.

The CHAIRMAN. Thank you very much. Mr. Kimmelman, welcome back.

STATEMENT OF GENE KIMMELMAN, DIRECTOR, CONSUMERS UNION

Mr. KIMMELMAN. Thank you, Mr. Chairman. On behalf of Consumers Union, the print and online publisher of Consumer Reports, I appreciate being invited back. Mr. Chairman, I almost don't know where to start. I'd like to lay out a few other facts that haven't been highlighted this morning, but I'll start with the one the GAO really did highlight. Per Senator Breaux's comment about Congress deciding to deregulate, the GAO found that in the few communities where there are two cable wires, you can get the same programming, the same infrastructure expansion, the same services, for 15 to 41 percent cheaper than where there is one cable companies and two satellite companies available. Isn't that important?

There has been a lot of statements made about the danger of distorting markets and Congress intervening. Congress is the biggest abuser of markets in this area. By giving away spectrum that was not auctioned off, by giving away franchises to monopoly cable companies, you've distorted the market from the get-go. We've got a digital transmission, we've got now proposals to prevent piracy, which in other words is prevent consumers from even copying something in their own home, with government oversight. Isn't it time to give some government respect to consumers' choices of what they want to watch?

Let's look at some of the facts. In return for all the investment cable has made, they have digital-tier services priced \$15 to \$20 a subscriber, they have cable modem high-speed services, they have additional advertising revenue, they have pay services, and those services cover the costs of the infrastructure investment with no need to raise basic rates. And yet the GAO has found that rates are going up almost three times faster than inflation, but not where there are two cable wires. What does that mean?

We can't change this overnight, but in reality, where there's digital service, you can offer consumers choice. In Canada, you can get from at least three major cable operators and a number of small ones, a digital package that's a basic package and you can pick 5 or 10 of your favorite channels for about 30 percent less than what cable operators offer their digital customers in the United States. I suggest we look into that.

Mr. Chairman, I think it's really time to call everybody's bluff on this one. When I have to hear that the cable companies that drive up every consumer's bills month in, month out, year in, year out,

and the programmers who drive up consumers' bills month in, month out, year in, year out, are the ones who are protecting consumers by blocking their choice and saying we're making you better off, something seems really fishy, something seems really wrong.

I urge you, Mr. Chairman, I urge you, Members of the Committee, to just do an experiment. Just ask the FCC to do a proceeding starting with digital-quality service to require that whenever the cable companies and the programmers put in anti-piracy devices, they put in consumer choice devices. Wherever everything is digitally capable and they can offer à la carte and there are no price increases involved, that they be allowed to offer every package, every single package they want with one simple government intervention, everything in that package also has to be offered à la carte.

So every channel that needs a boost to get started, if it could be in a package today, it could be in a package tomorrow and the next day. But if somebody didn't want that package, they could select the channel individually. Nielsen shows that on average American families, small cable systems only watch about 12 channels a month and larger systems watch no more than 17 channels a month. Seventy-five percent of viewing is of 20 channels. Are they the same channels? Go back and look at what's popularly rated today versus 10 years ago. Most of the channels that were high-rate, big viewership then are the same now. There are some new ones but not too many. Most of them that were not top 15 were top 25 then. That's what people want to see. Why not give them the choice?

Mr. Chairman, I just think it's time that rather than having theoretical debates, it's appropriate to do something for consumers. These rates keep going up every year, and whether you are for deregulation or you're for something else, something isn't working when the prices keep going up and yet where there are two cable wires they're not going up the same way.

We really need you to look at this seriously, and if the FCC fines in doing an experiment that everybody's prices go up, as was just said, stop it. If the FCC finds that major important programming that we find valuable from C-SPAN on isn't available, stop it. We would want you to stop it. But please try it. Thank you, Mr. Chairman.

[The prepared statement of Mr. Kimmelman follows:]

PREPARED STATEMENT OF GENE KIMMELMAN ON BEHALF OF CONSUMERS UNION AND
CONSUMER FEDERATION OF AMERICA

Consumers Union¹ and Consumer Federation of America² believe that cable television's continuous upward pricing spiral reflects a major failure of market forces and public oversight since Congress launched cable deregulation in 1996.³ In that time, cable rates have ballooned nearly three times faster than the rate of inflation. Indeed, according to the Bureau of Labor Statistics which measures cable rate increases and adjusts cable price increases by crediting the industry when it adds channels rates have shot up a staggering 56 percent since January 1996, while inflation increased by only 21 percent over that same period.⁴

One major explanation for these extreme price increases is the lack of competition facing cable companies. The fact is large cable operators simply do not compete with one another. Not one of the incumbent cable operators has ever expanded its infrastructure into an already-wired community and competed head-to-head. Instead, the major cable operators have through mergers and acquisitions become national firms, operating in regional clusters. These regionally dominant firms are positioned to keep out the few potential competitors who consider entering the cable arena.⁵ In markets where 98 percent of Americans live, a single cable operator dominates multi-channel video distribution with a market share exceeding 80 percent. (See Appendix A for a thorough analysis of cable's excess market power.)

Another contributor to soaring cable rates is the inability of satellite television to provide the pressure needed to keep cable rates down. Satellite has yet to emerge as an effective competitor to cable despite its growth in reaching more consumers and congressional efforts to help make satellite more competitive with cable. The General Accounting Office recently found that the presence of a second cable operator to compete head-to-head leads to consumers saving 15–41 percent⁶ off their bills, or an average of over \$5.00 per month.⁷ In contrast, the presence of satellite had almost no effect on prices, lowering rates an average of only about 20¢ per month.⁸ If we had head-to-head competition nationwide, consumers could save more than \$5 billion a year on those bills.⁹

¹ Consumers Union is a nonprofit membership organization chartered in 1936 under the laws of the state of New York to provide consumers with information, education and counsel about goods, services, health and personal finance, and to initiate and cooperate with individual and group efforts to maintain and enhance the quality of life for consumers. Consumers Union's income is solely derived from the sale of *Consumer Reports*, its other publications and from non-commercial contributions, grants and fees. In addition to reports on Consumers Union's own product testing, *Consumer Reports* with more than 4 million paid circulation, regularly, carries articles on health, product safety, marketplace economics and legislative, judicial and regulatory actions which affect consumer welfare. Consumers Union's publications carry no advertising and receive no commercial support.

² The Consumer Federation of America is the Nation's largest consumer advocacy group, composed of over 280 state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power and cooperative organizations, with more than 50 million individual members.

³ Public Law 104–104, The Telecommunications Act of 1996.

⁴ Bureau of Labor Statistics, Consumer Price Index (March 2004). From 1996 until March 2004, CPI increased 20.6 percent while cable prices rose 56 percent, 2.7 times faster than inflation.

⁵ For example, in Philadelphia, where Comcast has used "terrestrial bypass" to deny must-have sports programming such as the Philadelphia Flyers and the 76ers from satellite competitors, satellite penetration is 3.7 percent, compared to 10 percent of TV-viewing households nationwide. See Patricia Horn, "As Competition Lags for Cable TV, Prices Continue to Rise," *Philadelphia Inquirer*, June 3, 2001, page C01.

⁶ General Accounting Office, "Wire-Based Competition Benefited Consumers in Selected Markets": GAO–04–241, February, 2004, pg. 4.

⁷ General Accounting Office, "Issues Related to Competition and Subscriber Rates in the Cable Television Industry," GAO–04–8, October 2003, Appendix IV, p. 60.

⁸ *Id.*, pp. 60–61.

⁹ While we hope that satellite will ultimately have a price disciplining effect in those communities where satellite offers local broadcast stations, it is clear that the single most important variable in cable prices is whether there is a cable over builder in a particular community. Wire-to-wire competition does hold down cable rates and satellite does not seem to do the trick. The U.S. General Accounting Office describes this phenomenon:

Our model results do not indicate that the provision of local broadcast channels by DBS companies is associated with lower cable prices. In contrast, the presence of a second cable franchise (known as an overbuilder) does appear to constrain cable prices. In franchise areas with a second cable provider, cable prices are approximately 17 percent lower than in comparable areas without a second cable provider.

Satellite's growth as an effective competitor to cable has been hampered by technological constraints. For instance, satellite has so far failed to provide local TV channels in many areas, subscribers' homes must have unobstructed south-facing views to pick up signals, and satellite often requires more expensive equipment than cable. Also, cable has a competitive edge because it can offer consumers the advantage of television programming and a high-speed Internet service bundled together that delivers more capacity at a lower cost per megabit.

Unfortunately, just as satellite seemed positioned to begin to discipline cable pricing, the News Corp./DirecTV merger eliminated DirecTV's incentives to drive down cable prices, leaving EchoStar with virtually no capability to check cable price increases. This merger created a behemoth that has the power to raise prices across the board. News Corp's Chairman and CEO Rupert Murdoch publicly confessed this strategy after the purchase when he said, "we're not going into a price war with anyone."¹⁰

While the Federal Communications Commission (FCC) appropriately imposed merger conditions that prevent News Corp. from discriminating against cable and satellite providers, or unfairly bundling their most popular channels, the Commission failed to address News Corp. incentives to charge itself and all other distributors inflated prices for News Corp.'s programming.

In this transaction, the largest satellite provider has combined with one of the largest programming providers to create an unmatched vertical conglomerate. Even if News Corp. has to bargain with cable, it has every incentive to drive up the price it charges to itself, to its cable competitors, and to EchoStar using programming as its profit center. Mr. Murdoch is able to maximize his profits by raising programming prices for the more than 80 million potential cable/satellite viewers, rather than drive down prices to slowly grow his 12 million DirecTV customer base (which he controls, but reaps about 30 cents for every dollar of DirecTV profits). By charging DirecTV a high price for News Corp. programming, he is able to establish a price floor for programming that the rest of the cable industry and EchoStar will have to pay to obtain those same channels.

To make matters worse, the proposed merger between Comcast and Disney signals where the market as a whole is moving—towards significant vertical consolidation, where each big multichannel distribution system owns popular programming channels. Whether Comcast is eventually successful in a bid for Disney or not, cable and satellite distributors have plotted a course towards owning the most popular programming entities. For example, Comcast wants to own the most popular marquee programming, which will put the company in the driver's seat for and give them a cut of the prices it charges for ESPN, the ABC network, the Disney Channel, A&E, Lifetime, the History Channel, and ABC Family.

What's next? There are currently only about four companies logically positioned to combine with a cable distributor to create this kind of vertical firepower: GE/NBC, Time Warner, Viacom/CBS, and Disney/ABC. It seems that now the vertical genie has popped out of the bottle, there can only be greater pressure to combine programming and distribution assets. Collectively, these deals are likely to result in an arms race of cable programming price increases. Each vertically integrated media giant will have the same incentives to get top dollar for their programming. Will one of these giants refuse to pay top dollar for the other's channels, running the risk that other will retaliate in kind? Not likely. We believe it is much more probable that each media giant will pay high prices for each other's channels, knowing that all cable and satellite providers will have to pay as much or more for the same programming. The result: prices will keep spiraling upward for cable and satellite customers.

What is to be done? We urge Congress to intervene aggressively and force the FCC to do its job to ensure cable competition. The FCC has turned a blind eye to these obvious problems, failing to impose meaningful horizontal or vertical constraints that would keep these trends in check. But even if the agency reversed course today, it could not change fundamental market problems overnight. In the interim, we urge Congress to help empower consumers so they can begin to lower their cable bills by allowing them choose and pay for only those channels they watch.

By requiring that cable operators offer "à la carte" programming in conjunction with any other packages they wish to offer—the market power of the consumer's pocket book can be unleashed to begin to help lower programming costs, increase

In other words, where there are two satellite providers and one cable operator in a market, prices are 17 percent higher than where there are two cable companies and two satellite providers in a market.

¹⁰ Ronald Grover, "Direct Talk about DirecTV." *Business Week*, January 19, 2004, pg. 61.

incentives for programmers to provide quality fare to consumers, and give viewers the opportunity to not pay for content they find objectionable or too expensive.¹¹

Although cable operators vastly overstate the role of programming costs as a cause of rising cable rates, programming costs are a part of the problem. Cable operators have proven unwilling or incapable of bargaining down programming costs. As discussed earlier, this reflects the fact that they own a significant part of the most popular and expensive programming and they do not face effective competition from subscribers. Therefore, ownership weakens their interest in controlling these costs and they know they can always pass them through to consumers in the basic or expanded basic tiers. The best way to introduce discipline into the market is to let consumers vote with their feet (and their pocketbooks) by refusing to pay for channels they think are too expensive.

Few people regularly watch all the channels they must buy on cable. To purchase the small number of channels that consumers watch most, they must buy large service tiers from cable operators, ranging from 40, 50 to 75 channels or more. As the GAO cited, recent Nielsen Media Research data show the average consumer watches about 17 channels regularly¹², with the top 20 channels accounting for approximately three-quarters of all viewing.¹³ Unless cable companies charge outrageous prices for each channel, many consumers could save significant money on their monthly cable bill by selecting only the channels they actually watch. As Appendix B demonstrates, most of the channels consumers watch today are the very channels they watched years ago.

Giving consumers the choice to select only those channels they want also provides a unique solution to the growing public concern about violent and indecent programming. While technology such as the V-Chip allows consumers to block distasteful programming, many consumers find it insulting to have to pay for the very programming they find offensive. Instead of forcing consumers to buy service tiers that include programs they never watch or channels they find objectionable, policy-makers should require cable operators to let people pick and pay for only those channels they want.

Some cable operators might argue that technology prevents them from offering à la carte programming. While cable operators likely will have to make software adjustments inside the cable network to offer à la carte, systems that have been upgraded for digital cable would not require new technology in consumers' homes. And as cable operators will have to build in functionality to fight piracy (*i.e.*, the plug-and-play proceeding at the FCC) in the next year, now is the right time to consider enabling equipment to handle à la carte options. In Canada, a number of cable companies already offer consumers à la carte options.¹⁴

Cable operators have voiced concerns that they will have diminished advertising revenues if consumers are permitted to choose the cable channels they want to pay for and watch. However, advertising is based on total television viewership. Those who claim more choice in cable television programming means fewer advertising dollars are saying, in effect, that à la carte means people will watch less television. In fact, the opposite may be true; as consumers choose from a wider palette of options that will better cater to individual tastes, more TV viewership may be the result. People will simply be watching and paying for the programs they want.

Furthermore, the use of à la carte selection would enable advertisers to know more about their audiences, allowing the possibility of enhanced revenues from more targeted demographic information. Programmers should be able to charge more and advertisers should be willing to pay more for access to the viewers, because of the preference indicated by a willingness to pay for the programming. This will be a win-win situation because advertising will be more efficient at reaching a targeted audience.

¹¹ Consumers Union also believes that programmers should be required under a new set of nondiscrimination requirements to sell their channels to cable and satellite operators on a similar individual basis as we pointed out to the Committee in testimony last year. See written and oral statement of Gene Kimmelman before the Senate Committee on Commerce, Senate Commerce, Science, and Transportation Committee, *Cable Television and the Dangers of Deregulation*, May 6, 2003.

¹² GAO-04-08 Issues Related to Competition and Subscriber Rates in the Cable Television Industry, October 2003.

¹³ Consumer Federation of America and Consumers Union, *The Continuing Abuse Of Market Power By The Cable Industry: Rising Prices, Denial Of Consumer Choice, And Discrimination* In Access, p. 24.

¹⁴ A quick Internet search shows many Canadian cable operators—from the largest (Rogers) to some of the smallest (Northern Cablevision and Whistler Cable)—offer à la carte programming.

We would also like to allay some of the concerns that may be raised about certain cable channels suffering in an à la carte world. Appendix C shows that the most popular national cable channels are financially backed by broadcast networks or large cable companies. These entities need no special bundling “subsidy” to launch their programming. And Appendix D shows a sample of national channels launched by independent companies. Since most of these channels find it hard, if not impossible to be carried in cable’s expanded basic tiers, it is difficult to imagine that they would be worse off under an à la carte system.

Rather than allowing each and every spurious argument raised now by some cable operators to delay action on this issue, we urge Congress to instead listen carefully to what the industry itself said about à la carte pricing little more than a year ago. In testimony before this Committee in 2003, cable operators big and small endorsed pricing cable channels à la carte.

James Gleason, President and Chief Operation Officer of CableDirect, a small cable operator serving just 20,000 customers in the Midwest said, “To give customers choice and allow the market to determine what gets on TV, programmers should be required to make their services available as part of a separate programming tier. One solution might be to offer the expensive programming in tiers or à la carte.”¹⁵

Charles Dolan, Chairman of Cablevision, one of the largest cable operators with over 4 million homes in the Northeast, told this panel: “Cablevision, as a policy, wants its customers to be able to pick and choose among its services, selecting what appeals to them, rejecting what does not, determining for themselves how much they will spend, just as they do every day in the supermarket or shopping mall.” He continued with an analogy I’ve heard repeated since then, “To help the dairy industry, I ask, would the government insist that all customers be required to buy a dozen eggs and a quart of milk before they can purchase their bread?”¹⁶

If the FCC can force manufacturers to rebuild entire classes of technology to fight piracy and adhere to the Plug and Play specifications, and if the FCC can plant a Broadcast Flag to expedite the transition to digital television, surely policymakers can also give consumers more choice in cable programming. It is time for Congress and the FCC to put consumers’ interest on equal footing with industry goals, and let market forces begin to provide much needed discipline on exorbitant cable rates. And it is also time for policymakers to empower consumers to keep distasteful programming out of their homes.

APPENDIX A

THE CONTINUING ABUSE OF MARKET POWER BY THE CABLE INDUSTRY: RISING PRICES, DENIAL OF CONSUMER CHOICE, AND DISCRIMINATORY ACCESS TO CONTENT

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¹⁵Testimony of James Gleason, Hearing on Media Ownership, Committee on Commerce, Science and Transportation, May 6, 2003, p. 53.

¹⁶Testimony of Charles Dolan, Hearing on Media Ownership, Committee on Commerce, Science, and Transportation, May 6, 2003, p. 56.

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THE CONTINUING ABUSE OF MARKET POWER BY THE CABLE INDUSTRY: RISING
PRICES, DENIAL OF CONSUMER CHOICE, AND DISCRIMINATION IN ACCESS

Executive Summary

Eight years after the passage of the Telecommunications Act of 1996, which deregulated cable prices, this study shows that cable operators still possess market power in the multichannel video market. The result is price increases that far exceed the rate of inflation—almost three times faster than inflation in recent years—and the continued restriction of consumer choice to a small number of ever larger, ever more expensive bundles. The cost imposed on consumers by this abuse of market power is between \$4.5 and \$6 billion per year, compared to what prices would be in a competitive market.

Cable operators attempt to obscure the existence and abuse of market power with two arguments. First they claim that programming costs explain the massive increase in the price of basic and expanded basic service. Second, they claim that consumers are getting much greater value for their dollar; so that quality adjusted prices have declined. Neither claim stands up to close scrutiny.

Exercise of Market Power on the Supply Side

Prices

Econometric studies by the General Accounting Office and the Federal Communications Commission show that where cable faces direct head-to-head overbuilder competition the price of cable service is much lower.

- A recent GAO report found that in situations where cable faces competition overbuilders, prices are 15 percent lower. Econometric analyses have consistently found this result of a decade. Unfortunately, less than two percent of cable customers enjoy the benefits of that competition.
- A recent GAO analysis found that a cable system owned by a large national operator has prices that are over 5 percent higher than if it is not. FCC econometric models show even larger effects.
- When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.
- The vast majority of cable subscribers are now served by one of a handful of huge-multiple system operators that have expanded their grip on the industry through mergers and clustering, who adds as much as an additional 8 percent to the consumers bill.

Market Structure

Cable's market power stems from a lack of effective competition. Even at the national level, the multichannel video market has become concentrated; the problem is much greater at the local level.

- In markets where 98 percent of Americans live, a single cable operator dominates multichannel video distribution with a market share that exceeds 80 percent.

The largest cable operators never compete with one another. Instead they have grown to huge national firms through mergers using swaps of systems to create regional clusters that undermine the ability of overbuilders to launch competition. Large operators and clustered systems have more muscle to thwart competition and impose price increases.

- They can distribute programming terrestrially and refuse to make it available to competing distribution systems. This is becoming increasingly important as vertically integrated companies dominate "must have" regional sports programming.

- They can extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media.
- They have more leverage over local governments to obstruct the entry of over-builders

Direct Broadcast Satellite does not have a significant or substantial ability to discipline cable pricing abuse. Satellite is a niche product that has had its greatest success in areas where cable was unavailable or among customers who wanted high quality digital services with large numbers of channels (before cable could offer such a package).

- Cable has surpassed satellite in the number of subscribers to digital video service.
- It is bundling high-speed Internet and basic cable service to further erode the ability of satellite to compete.

Discrimination in Access

Cable operators discriminate against unaffiliated service providers in both the video and the high-speed Internet product space. Cable operators are 64 percent more likely to carry networks that they own, than the networks provided by others. Broadcasters have used their retransmission rights to also gain preferential carriage deals for their shows. As a result, independent programmers are placed at a severe disadvantage.

Cable operators dominate the residential market for advanced high-speed Internet access, with an 83 percent market share. By refusing to allow unaffiliated Internet Service Providers to compete for Internet access customers over the cable modem platform, cable operators have foreclosed a critical high-end market, which dramatically reduces competition for Internet service. Virtually no voluntary carriage agreements have been signed by cable operators.

Cash Flow

A close look at cable's financial operations shows that rising costs cannot explain the rising price of traditional video services.

- In the aggregate, price increases far exceed the increase in programming costs.
- An allocation of non-programming operating costs based on historical patterns shows that operating cash flow from traditional video services has increased by approximately 70 percent on a per subscriber basis since the passage of the Telecommunications Act.

Sale of advanced services, digital tiers and high speed Internet, which were the motivation behind the recent system upgrades, has skyrocketed. The upgrades are paying for themselves.

- High-speed Internet is now the second largest income stream and digital tiers are the third largest streams of income for the cable operators, bringing in a combined \$10 billion per year.

The Shape of Market Power on the Demand Side

Cable operators claim that adding more channels to their bundles increases the value of the package. Unfortunately, consumers are not given a choice of which channels to purchase. They must take nothing, almost nothing (basic) or almost everything (expanded basic). With the addition of the digital tier, they have another option, but cable operators have been moving popular channels (like HBO) to the digital tier to drive consumer bills up even farther.

Because the cable operators restrict consumer choice to this small set of bundles, it is impossible to know how consumer welfare has changed and wrong to claim that every show adds equally to consumer value.

- The average consumer watches about 17 channels regularly, but the bundles have four times that number.
- The top twenty shows account for approximately three quarters of all viewing.
- Almost nobody watches the bottom 30 channels in the bundle. Only about one out of every 250 households where these shows are available watches them on any given day.

The economics literature has long recognized that bundling by firms possessing market power can be anti-consumer and anticompetitive. When different consumers have strong preferences for different channels, putting them into bundles forces each consumer to pay for many channels he or she does not want in order to get the channels he or she does want.

A detailed analysis of one of the most popular and expensive channels, ESPN, which has been a focal point of controversy, shows that approximately four-fifths of cable subscribers would not pay the price of ESPN if they were given a choice. By forcing consumers to pay for the show in a bundle, wealth is transferred from consumers to cable operators (and the programmer).

A recent analysis that claims that the BLS over states price increase and that prices have fallen on a quality adjusted basis is riddled with analytic and measurement errors. The analysis double counts the quantity of programming and vastly overvalues the shift from viewing over the air to viewing cable. Watching an hour rerun of the same show on cable, instead of a broadcast station is assumed to increase consumer value by one hour, even though the exact same show is watched. Correcting these errors shows that the BLS cable price index yields, at best a lower limit on the quality adjusted price increases.

- In contrast to the 15 percent real decline that the NCTA analysis claims, the BLS shows a 27 percent increase. The actual quality adjusted price increase could be as high as 40 percent.

The embedded base of excess prices and the entrenched market power of the cable operators, reinforced against satellite and extending into the high-speed Internet, confront policy makers with a critical problem. After two decades of abuse, and eight years after the Telecom Act of 1996, it is clear that policymakers made a mistake in deregulating cable. It is time for policymakers to take steps to promote real competition and protect consumers from further abuse.

APPENDIX A

Introduction

A. Purpose

Proceedings at the Federal Communications Commission (FCC),¹ a series of General Accounting Office (GAO) reports² and contract negotiations between cable operators and programmers³ have stimulated an unprecedented round of finger pointing and release of data about the cable television industry. The goal is to justify and/or place blame for the dramatically increasing price of cable service.⁴ Cable operators claim the programmers made them do it. Programmers have fired back, suggesting that basic rates have been increasing to support the rollout of advanced video and new, non-video services. The finger pointing drives home a simple point: consumers are paying a dramatically higher price for their monthly cable service. Or, are they?

Several of the existing industry studies are framed as responses to consumer analyses that have documented the abuse of market power by cable operators. Comcast⁵ and the National Cable Telecommunications Association (NCTA)⁶ assert that when consumer advocates complain about the total price of cable service, they are failing to take into account that the monthly bill includes more networks and are confusing real prices with nominal prices. NCTA goes so far as to offer a new approach to indexing cable prices as an alternative to the Bureau of Labor Statistics (BLS) cable Consumer Price Index (CPI). The FCC's *Tenth Annual Report (In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)* cites this analysis as further support for its conclusion that competition in the multichannel video market is robust and repeats the industry arguments.⁷

This paper shows that the most frequent complaint voiced by consumer advocates—that cable “rates have risen and continue to rise almost three-times faster than inflation,”⁸—is correct. The consumer advocate comparison of cable rates to inflation states the numerator and the denominator of the real fraction in a fashion that is more meaningful to consumers and policymakers because it gives the reference points. Moreover, the paper argues that, if anything, the BLS cable price index is more likely to be understating price increases than overstating them. The bottom line is that the market power-based abuse of consumers by cable operators has been growing since the passage of the Telecommunications Act of 1996. After two decades of blatant abusive pricing, cable operators have begun to encounter some resistance, so increases may slow, but that does not mean the abuse will be reduced or eliminated. In response to criticism, the cable operators have simply launched new bundling strategies that shift the focal point of price increases and anticompetitive harm to other areas.

B. The FCC's Failure to Ask the Hard Questions

The FCC's Annual Reports have steadfastly refused to address the serious questions raised about the cable market in a rigorous manner, but the *Tenth Annual*

Report sinks to new lows. The FCC cannot even figure out how many cable subscribers there are. The two sources on which it relies for data (it never generates its own independent data) disagree by almost five million subscribers. In response, the FCC takes a most remarkable approach—it uses both sets of numbers—the lower figure for its financial analysis and the higher figure for its assessment of competing technologies (contrast Tables 1 and 4 to Table B-1). The *Ninth Annual Report* used the higher figure for both the financial and the competitive assessment analyses.

As with most analyses at the Commission these days, slipping the lower figure into this report may be strategically motivated. If the FCC uses the higher figure and growth persists at the rate implicit in those figures, by this time next year cable will be well above 70 percent of the TV market. This is a threshold that would trigger petitions to the FCC to regulate cable. If the FCC shifts to the lower figure, or claims the conflict between the two creates uncertainty, the regulation trigger would be put off several years. Here, as elsewhere, the failure of the FCC to develop solid independent data may harm consumers substantially.

The FCC recognizes the dramatic increase in cable prices, but, like the industry, it emphasizes that “concurrently with these rate increases, however, the number of video and non-video services increased, including a substantial increase in the number of video channels, increased use of cable (as measured by a substantial increase in cable viewership), and the addition of advanced service offerings which, of course, are paid for separately by consumers.”⁹ Unfortunately, the FCC admits that its approach to measuring prices cannot address the fundamental issue, since it is based on an assumption that this paper shows to be doubtful—“Per channel rates, however, value all additional channels the same even if consumers do not want new channels that are added to cable systems.”¹⁰ This paper shows that such an assumption is contradicted by consumer behavior. The cable video industry’s bundling harms consumers.

The FCC regurgitates the industry claim that rising programming costs have driven basic rate increases, but does not examine the contradictory evidence embedded in its own numbers. For example, it notes that programming costs went from \$7.5 billion in 1998 and will exceed \$9 billion in 2003.¹¹ It later cites a figure of \$9.2 billion for 2002.¹² Over the 1998–2003 period, revenues for basic and expanded basic services increased by \$7.3 billion. Thus, three quarters of the price increases cannot be explained by rising programming costs. Price increases exceeded programming cost increases by more than \$5 billion.

The challenge of explaining away the excessive rate increase for basic and expanded basic service is made all the more difficult in light of the dramatic increase in revenues from advanced services. The FCC notes that dramatic rise of advanced service revenues citing “Kagan World Media reports it was high-margin, high-speed-data services that drove operating cash flow growth in 2002.”¹³ Moreover, it notes that Kagan sees this trend growing in 2003, since “they expect high-speed data service ‘to contribute 12.4 percent to total residential revenue, the largest piece of the revenue pie after basic service.’”¹⁴ Digital tier services are the third largest revenue stream for cable operators, having surpassed local advertising for the first time in 2003.¹⁵ The fact that these two advanced services now bring in \$10 billion in revenue should force the Commission to challenge the claim that basic and expanded basic prices had to rise to pay for the upgrade of the system. This issue, which the Commission has never addressed, is a central theme of this report.

The FCC’s report goes on to claim that the bundling of advanced services with basic service “may provide some discount on basic or expanded basic,”¹⁶ a proposition it does not even attempt to analyze, let alone prove. This paper shows that this bundling is anti-competitive.

The FCC notes several cable industry milestones in this report, but fails to follow up on them. For example, it notes that the national Multichannel Video Programming Distribution (MVPD) market exceeds the threshold for a moderately concentrated market as defined by the Department of Justice/Federal Trade Commission *Merger Guidelines*. The FCC hastens to add that “it is unclear whether this is a potential competitive problem, because the delivery market is local, not national and because the main competitors to cable in both the upstream and downstream markets continue to grow in size.”¹⁷ This observation is not comforting for several reasons.

As has traditionally been the case, the FCC makes no effort to assess the level of concentration in the local market. If it did so, it would find that local MVPD markets are generally six times as concentrated as the national market on which it focuses.¹⁸ Here the FCC encounters another contradiction. It continues to maintain that the clustering strategies of large multiple system operators might benefit con-

sumers,¹⁹ even though the Commission's own analysis has consistently shown that clustering results in higher prices.²⁰

While it is true that the MVPD market is expanding, the FCC fails to note that its competitive assessment analysis shows that cable operators added more subscribers than all the other MVPD competitors combined.²¹ (Of course, the FCC may erase this observation by switching the numbers next year.) Moreover, the FCC fails to note that cable surpassed satellite in the number of digital subscribers for the first time in 2003.²² Thus, the competitive threat from satellite that the FCC claims should ease our concern about concentration in the cable market may be subsiding, if it ever existed. In fact, this paper reviews the evidence that satellite has failed to discipline cable's pricing abuse.

The FCC's simplistic parroting of the industry arguments and failure to conduct rigorous, independent analysis continues to disserve consumers. As cable prices mount and the industry extends its market power into new areas, "congress and American consumers deserve a better effort from the FCC."²³

II. The Supply Side

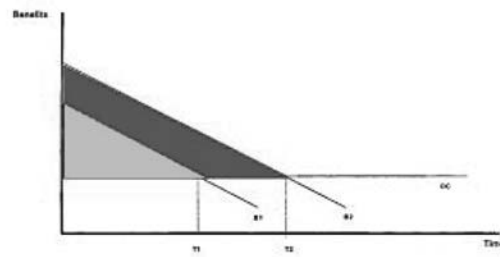
A. Market Power 101

All of the industry studies, as well as the FCC report, ignore the fundamental public policy issues raised by the consumer analysis. Simply put, every dog has his day and every monopolist has his profit-maximizing price. Unlike the hapless canine, however, who goes back to a dog's life when his day is done, when the monopolist hits his profit-maximizing price, he goes on collecting excess profits. The abuse of consumers persists. What the cable industry economists have done in their recent papers defending cable industry prices is to focus on the scraps of consumer surplus left on the table by cable operators and ignore the submerged danger, the transfer of wealth and deadweight efficiency loss that result from the abuse of market power.²⁴

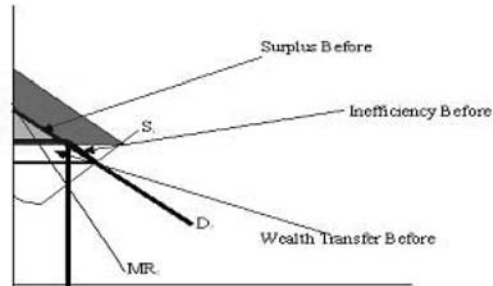
Launching from the simple observation that every monopolist leaves a little surplus in consumers' pockets, the cable industry analyzes the tip of the market power iceberg (see Exhibit 1a).²⁵ The shaded area in Exhibit 1a is the focal point of the NCTA paper. Consumer surplus (or consumer benefits as the paper calls them) is measured as the difference between the value of a service to the consumer (as indicated by the demand curve) and the price the consumer pays for the service. If the value exceeds the price, the consumer buys the product.

EXHIBIT 1: Consumer Surplus

a) NCTA'S Simplistic Analysis



b) Consumer surplus is the tip of the market power iceberg



c) Change in supply and demand with market power persisting

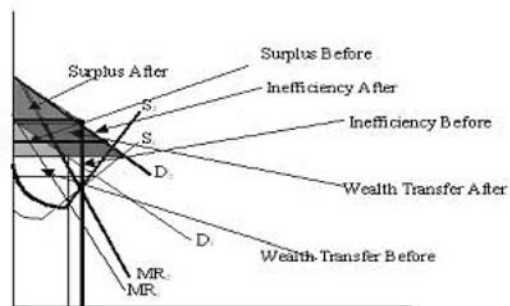


Exhibit 1b places the consumer surplus analysis in the framework of the complete picture of cable pricing²⁶ as a classic diagram of the exercise of market power over price.²⁷ It is well known in economics that the monopolist sets his price at the point where marginal revenue equals marginal cost. Even at that price there are consumers who are willing to pay the price because the value of the service exceeds the price for them, but consumers are still paying too high a price for the service. The monopolists have captured part of the consumer surplus and transferred it to their pockets (wealth transfers). Also, there are some consumers who give up cable or do not take it, when they would have if the price had been at a competitive level. Their loss is a deadweight efficiency loss. Because the elasticity of demand for cable service is low, wealth transfers are large relative to efficiency losses.

The monopolist can do various things to increase his profits when he hits the profit-maximizing price (see Exhibit 1c).²⁸ He can stimulate demand by adding value or by bundling. He can shift the supply curve by lowering his cost or changing his cost structure (and pocket an extra share of the cost savings because he does not face competition). Either or both of these may appear to be welfare enhancing because the quantity consumed increases, but the abuse actually may be increasing on a relative basis because more consumer surplus is being extracted.²⁹ The relative size of the effects depends on the specific supply and demand curves. This is an empirical question. As depicted in Exhibit 1c, this paper demonstrates that both the total profit and the rate of profit on traditional video services have increased since the passage of the 1996 Act.

B. GAO's Video Market Structure Analysis

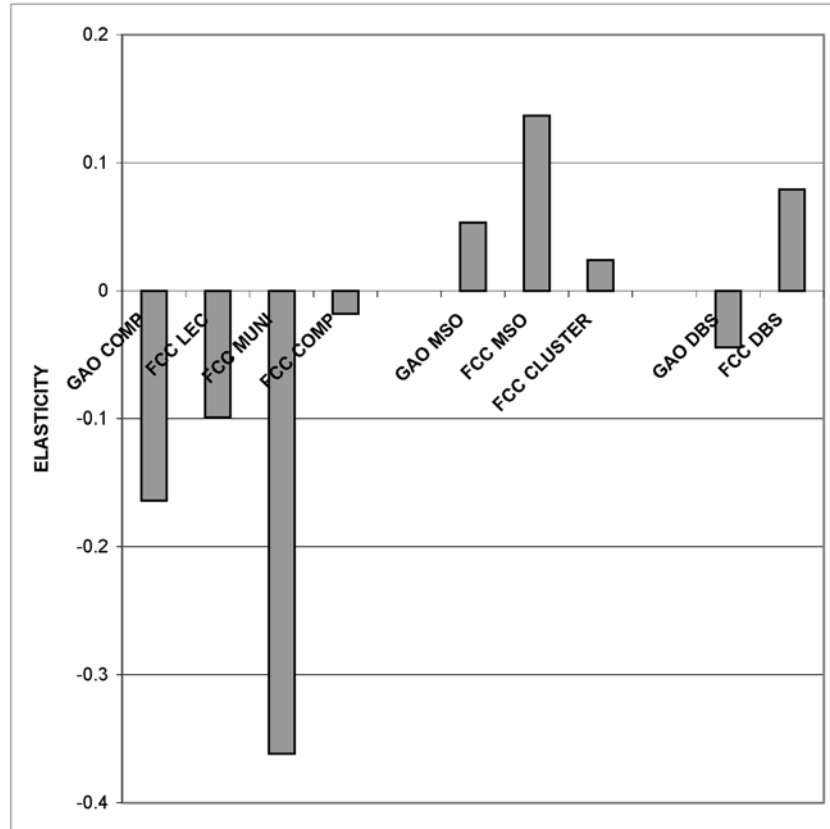
The critical first question that must be answered is simple—is there evidence that market power is being exercised on the supply side? The GAO provides an affirmative answer. The GAO report affirms each of the supply-side problems of the multi-channel video market that has afflicted the American public since the industry was prematurely deregulated in 1984 and further deregulated in 1996. Exhibit 2 shows the elasticities for dummy variables measuring various structural characteristics that affect the extent of competition, which were included in the regression analyses conducted by the GAO and the FCC.

1. Horizontal Market Power

Head-to-head, wireline competition is the only market structure feature that significantly disciplines monopolistic pricing. In its most recent report, the GAO finds that head-to-head, wireline competition between cable operators lowers prices by 15 percent for basic and expanded basic service.³⁰ Its earlier report had found a 17 percent difference.³¹ Ironically, the *Tenth Annual Report* notes that the first report on cable competition found that head-to-head competition lowered prices by 16 percent.³² Recent FCC econometric models, which identified three types of head-to-head competitors (local exchange carriers (LECs), publicly owned systems (munis) and other private overbuilders (comp)), have consistently found large price effects from head-to-head, wireline competition.³³ Unfortunately, less than two percent of American households enjoy the benefit of head-to-head, wireline competition.³⁴ The result is an abuse of market power that costs the American public about \$4.5 billion per year in cable rates alone.³⁵

EXHIBIT 2: Impact Of Market Structure Characteristics On Monthly Rates

(Regression Coefficients, dummy variables)



Sources: Federal Communications Commission, *Report on Cable Prices*, April 4, 2002, Attachment D-1; General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003, Appendix IV, Table 3.

Bigger monopolies are worse when it comes to consumer prices. In the GAO analysis, if a cable system is part of a large national operator, its prices are 5.4 percent higher than if it is not.³⁶ The GAO called this horizontal concentration. FCC econometric models have been finding this to be the case for several years, with even larger effects of being part of a multiple system operator (MSO).³⁷ When the FCC models add in a specific variable for regional clustering, a dramatic trend in the industry, they find that clustering has an added effect of further raising price.³⁸ Being served by one of the mega-multiple system operators, who have been expanding their grip on the industry through mergers and clustering, drives prices higher by more than 5 percent and perhaps as much as 8 percent. Thus, there could be as much as an additional \$1.5 billion in consumer savings that could be wrung out of the cable market if it were deconcentrated.

The important implication is that the theory used to allow large cable operators to become larger is not supported by the empirical evidence.³⁹ That theory claimed that the combination of larger, clustered systems would create efficiency-based cost savings that would be passed on to the public because one big monopolist is no worse than two, contiguous smaller ones. Since large incumbents never overbuild one-another and compete, this theory claimed there was little to be lost. The econometric evidence suggests that there is considerable harm. It turns out that large operators and clustered systems have more muscle to thwart competition and impose

price increases. They can distribute programming terrestrially and extract exclusivity deals from independent programmers, thereby denying programming to competing distribution media (overbuilders and satellite). They have more leverage over local governments to obstruct the entry of overbuilders.

The large incumbent cable operators never competed by overbuilding a neighbor, they grow by merger. Policymakers surrendered to the cable urge to merge too easily. If cable operators knew they could not grow through mergers and really cared about size, they might compete by overbuilding one another.⁴⁰

Intermodal competition—between cable and satellite—does not effectively discipline cable's pricing power. In contrast to head-to-head, wireline competition, which lowers cable bills by \$5 per month, competition from satellite lowers bills by a mere \$.15, according to the GAO.⁴¹ In other words, head-to-head, wireline competition is almost 40 times as effective as intermodal competition when it comes to price. In fact, in the GAO report, even satellite's very modest pricing effect is not statistically significant by traditional standards. It fails at the 5 percent level of significance. The FCC's econometric analysis does not find even this small price effect. It finds a statistically significant effect in the opposite direction.⁴²

To the extent that satellite has any competitive effect, it drives cable operators to offer more channels, but this effect stems from the decision of satellite to offer local programming. Where satellite offers local programming, cable operators offer about 5.4 percent more cable channels. Thus, satellite appears as a niche product that cannot discipline cable pricing abuse for the vast majority of cable subscribers who take only basic and expanded basic.⁴³

Exhibit 3 explores the implications of the most recent econometric findings on horizontal market power. Using the traditional measure of market power and the standard measure of the pricing abuse that results—the Lerner Index—it explores the relationship between the number and size of firms in cable markets and the mark-up of price over cost. A more advanced approach uses the level of concentration in the market (as measured by the HHI) in the Lerner Index instead of the simple number of firms. The mark-up of price above cost is inversely related to the extent of competition and the market elasticity of demand. The more competitive the market and the more elastic the demand, the less the ability to increase price. The analysis uses the econometric estimate of the elasticity of demand and the implicit levels of concentration. The econometric estimate of a 20 percent mark-up from a lack of head-to-head competition and horizontal concentration is consistent with, even a conservative estimate of, the pricing power suggested by the market structural conditions (demand elasticity and market shares) implicit in both the GAO and the FCC analyses.

2. Vertical Market Power

Vertical relationships are exploited by cable operators. GAO finds that cable operators are majority owners of one-fifth of the top 90 national networks. The GAO does not find price discrimination but it does find discrimination in carriage. That is, cable operators do not pay themselves more for their own shows, but they are much more likely to air them. The effect is quite large. Cable operators are 64 percent more likely to carry the programming in which they have a majority ownership stake. Cable operators who have a stake in programming also carry fewer channels overall. This result is consistent with prior academic studies.⁴⁴

A one-fifth share of the most popular programs is a very substantial stake in the programming market and it blunts cable operators' incentive to resist price increases. Cable operators own minority stakes in other networks. With their market power at the point-of-sale, cable operators know that they can pass costs through to consumers and they can assure that their own programs are carried much more frequently than those of others, thereby gaining a disproportionate share of the overall increase in programming costs.

While no cable operator had pricing power in the programming market until recently, Comcast appears to have gained pricing power as a large purchaser of programming. Having achieved a large enough market share, it now has monopsony power over sellers of programming. Comcast is squeezing programmers to lower their fees at the same time it is announcing price increases for basic and expanded basic. It is both reallocating rents from programmers to itself⁴⁵ and increasing the rents collected from consumers.⁴⁶

Rights of carriage matter a great deal in the cable industry. The decision of Congress to give broadcasters must carry/retransmission rights has enabled the broadcasters to gain a significant advantage for their programming, in terms of carriage. Programs owned by broadcasters are 41 percent more likely to be carried by cable operators. Clearly, independent programmers are at a severe disadvantage, as has been demonstrated time and again. Although the GAO report concludes that 38 per-

cent of the cable networks are majority owned by non-cable, non-broadcast firms, a much smaller percentage, less than 20 percent, do not have at least some minority ownership of broadcasters or cable operators.

**EXHIBIT 3: Comparison of Empirical Estimates of Mark-Up Using
Alternative Measures of Concentration and Dummy Variables**

SOURCE	CONCENTRATION MEASURES		ΔL
	Non-competitive	Competitive	
FCC ($E_d = 2.2$)	<u>HHI = 6800</u> 45.1	<u>HHI = 3912</u> 17.8	-27.3
DIRECT ESTIMATE			
Head-To-Head			- 9.1
Concentration			<u>-25.6</u>
Total			-34.1
GAO ($E_d = 1.54$)	<u>HHI = 7312</u> 47.4	<u>HHI = 3418</u> 22.2	-27.3
DIRECT ESTIMATE			
Head-To-Head			-15.1
Concentration			<u>- 5.4 to -8.0</u>
Total			-20.5 to 23.5

Sources: Federal Communications Commission, *Report on Cable Prices*, April 4, 2002, Attachment D-1; U.S. General Accounting Office, *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003, Appendix IV, Table 3. Viscusi, W. Kip, John M. Vernon and Joseph E. Harrington, Jr., *Economics of Regulation and Antitrust* (Cambridge, MA: MIT Press, 2001), pp. 102-108, 147-149, 258-259. Lerner Index:

$$L = S_i \frac{(P_m - MC)}{P_m} = \frac{HHI}{10000} * \frac{1}{E_d} \text{ (Nash Equilibrium)}$$

While discrimination in carriage has implications for the pricing issue that is the central concern of this paper, it has much broader implications for public policy in the multichannel video market. Public policy has expressed a concern about promoting independent production and ensuring a diversity of content for decades. Two pending proceedings at the FCC directly involve the question of how concentration of ownership and the exercise of market power in the form of discriminatory access to distribution affect the content available to the public. In the horizontal limits proceeding, the FCC is charged with setting a limit on the market reach of a single cable operator.⁴⁷ Similarly, in several of the media ownership proceedings the market reach of broadcasters (and the availability of cable as a distribution technology) is a central concern. The conclusion is overwhelmingly clear. Those who have Congressionally mandated rights of carriage are able to have their shows aired, those who do not have almost no chance of success.

C. High-Speed Internet

Although high-speed Internet raises many important issues, from the point of view of video services pricing, it plays two important roles.

First, it is cited by the industry and analyses as one of the causes for the increase in cable prices. Since the plant upgrade supports other streams of revenue, the GAO cautions, “[f]irst, depreciation expenses (and therefore infrastructure investment) represent a joint (or common) expense for both video-based and Internet-based services. Because these expenses are associated with more than one service, it is unclear how much of this cost should be attributed to video-based services. Second, cable operators are enjoying increased revenues from these non-video sources.”⁴⁸ The same is true for operating expenses. A large part of the increased expense is associated with the selling and servicing of advanced video, Internet and telephone service that “have been spread across the entire revenue base—i.e., they are reflected in the prices paid by basic cable subscribers.”⁴⁹

Looking at a short period, 1999 to 2002, the GAO finds that revenues from Internet services alone are already almost equal to the increased depreciation expense of the cable plant upgrade. The GAO estimates that capital costs (depreciation ex-

penses) have increased by \$80 per subscriber, while Internet-only revenues increased by \$74.⁵⁰

Second, cable operators have rapidly achieved positive cash flow from high-speed Internet services because of weak competitive forces. Cable operators are aggressively bundling high-speed Internet with video services to gain competitive leverage. Their market power over high-speed Internet access gives them an important anti-competitive tool. Cable has foreclosed competition for Internet access service over its platform.⁵¹ Controlling the platform diminishes the potential competition from video streaming over the Internet⁵² and becomes a lever against competition from other distribution technologies. Cable has an 83 percent market share of the residential advanced high-speed Internet market.⁵³ Moreover, cable provides overwhelmingly (87 percent) advanced service, while DSL is overwhelmingly (67 percent) not advanced.

Discrimination was even more brutal in the Internet space as cable operators applied their business model to high-speed Internet access. Only a consent decree forced Time Warner to allow modest access, and intense scrutiny forced AT&T to make some minor concessions, but the recent AOL/AT&T carriage agreement is thoroughly anticompetitive.⁵⁴ AOL has been unable to actually execute any carriage agreements with cable companies.⁵⁵ Cable operators do not sell ISP services outside of their service territories where they have the leverage of their market power over cable facilities.

With intramodal competition foreclosed, cable faces only weak intermodal competition. Cable has scoffed at the modest discounting efforts of the telecommunications-based DSL service providers.⁵⁶ In fact, Comcast raised the price of stand-alone high-speed Internet on its newly acquired AT&T systems. The reason cable can ignore intermodal competition is simple; those discounted services are substantially more expensive on a megabit basis (see Exhibit 4). The cable operators ignore DSL pricing moves and harp on speed superiority in their advertising. Exhibit 4 also shows why dial up is not a substitute for high-speed access. It is far more expensive on a megabit basis. Moreover, dial-up lacks the other key feature of high-speed service—it is not always on. This distinction led the Justice Department to declare early on that high-speed Internet is a separate product from dial-up.⁵⁷

Satellite lacks the ability to offer a bundle of video and high-speed Internet to compete effectively with cable. Cable recognizes this and is aggressively bundling high-speed Internet with basic cable service—offering a 25 percent discount on a bundle of basic cable and Internet compared to stand alone Internet service.⁵⁸

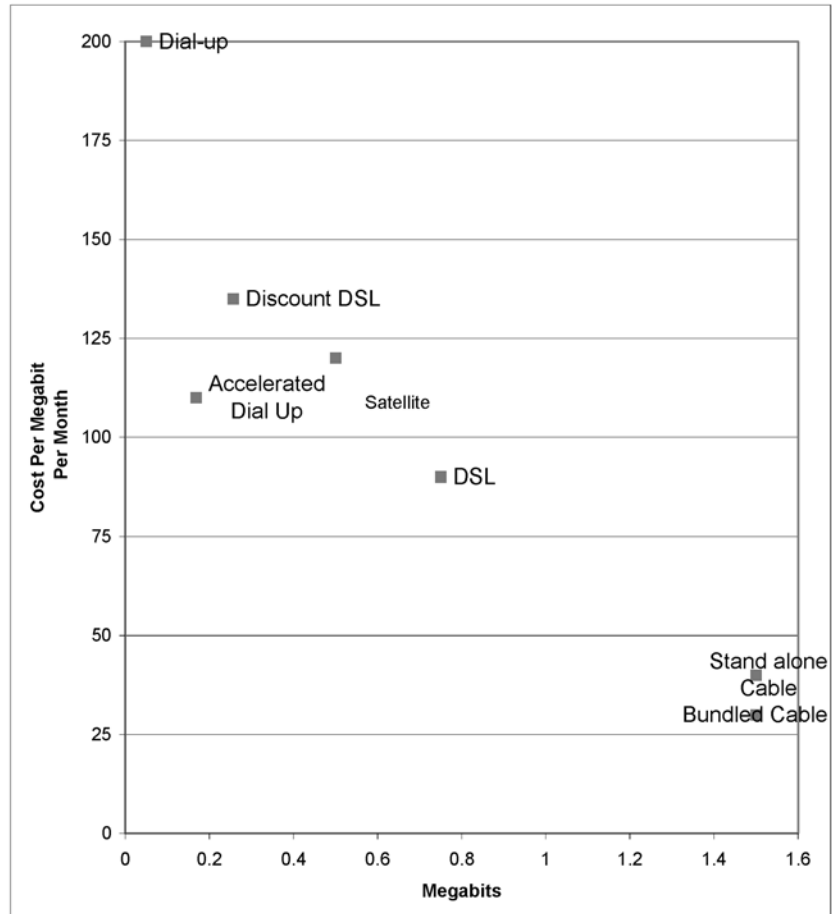
Looking carefully at specific product and geographic markets reveals little competitive overlap of different facilities (see Exhibit 5).⁵⁹ Intermodal competition is weak at best. Technological differences give different facilities an edge in different customer and geographic markets.⁶⁰ Cable dominates the advanced residential high-speed Internet market, with a 75 percent market share for residential market of speeds of greater than 200kbps in both directions.⁶¹ DSL, as deployed, is ill suited to multimedia video applications,⁶² but DSL dominates the non-residential market with a 95 percent market share because businesses are disinclined to use cable.⁶³ For the next generation telephone network technologies, “most experts agree that the VDSL business case isn’t for everyone and won’t⁶⁴ realize its full revenue potential for decades.”⁶⁵

However, cable operators devote less than two percent of the capacity of their systems to cable modem service. They could easily expand that if they so desired. This gives them an immense advantage over telephone companies.⁶⁶

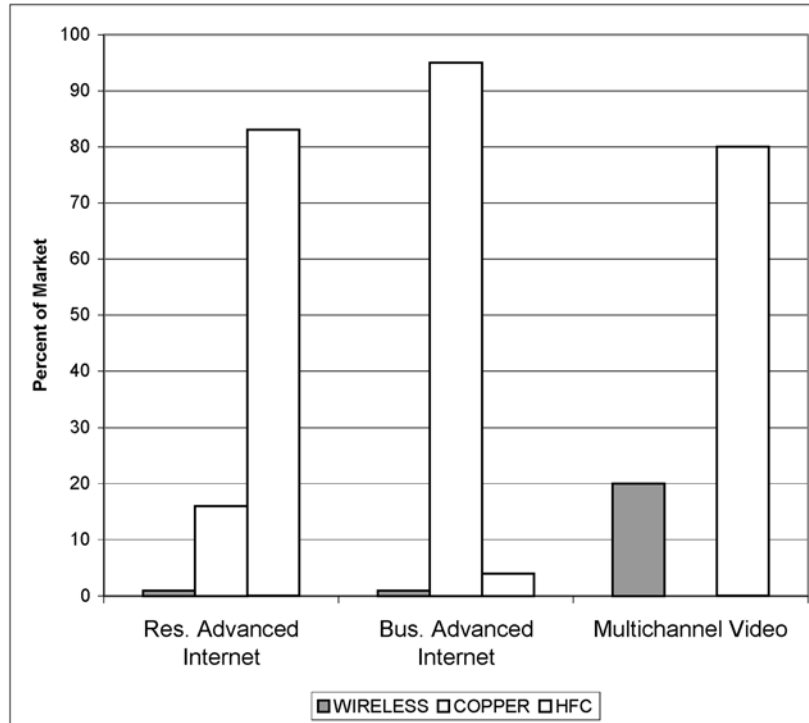
D. Cash Flow Analysis

1. All Revenues, All Costs

To assess whether the rate increases of recent years have been abusive, I analyze cash flow. I use 1995 as the base year, since the Telecommunications Act of 1996 was signed in early February. For several reasons, it is important to capture this whole period. Industry analyses, including that of the GAO, choose a very short time frame, 1999 to 2002, and miss critical factors.⁶⁷

EXHIBIT 4: The Price of High-Speed Internet Service

Source: Calculated by author from website visits.

EXHIBIT 5: Market Segmentation Of Services Between Technologies

Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table Appendix B. *High-Speed Services for Internet Access*, December 2003, Table 1, 2 and 4; *Local Telephone Competition: Status as of December 31, 2002*, June 2003, Tables 1, 13; NCTA, Overview 2003: Mid-Year, p. 1.

First, the upgrade of the cable plant began well before 1999, as did the post-1996 Act rate increases. By 1999, the cable industry had already upgraded one-third of its plant. Rates for basic + expanded service had already increased by 50 percent and net operating income (operating revenue minus operating costs) had increased by over 25 percent. In fact, just one year after the passage of the Telecommunications Act of 1996 the issue of cable rate increases had already arisen. The FCC's January 1997 cable price report noted that "the Cable CPI increased at a 3.7 percent compound annual rate from January 1995 to December 1995, and at a 8.5 percent compound annual rate for the eleven months from January 1996 to November 1996."⁶⁸ The song and dance about the causes of the increases had already begun, when the Commission declared:

we note from anecdotal evidence reported in both the trade press and the general news media that cable operators have attributed the recent increases in cable rates to higher programming costs, system upgrades which provide additional channels, and the pass through of the effects of general inflation on operators' costs.⁶⁹

Second, the GAO report does not examine all of the revenues and costs consistently, since it never factors in advertising revenue. It appears to underestimate an important source of revenue, digital tier revenue, and an important cost stream, non-programming operating expenses. The GAO did not break out the revenues from advanced video services that are also made possible by the upgrade.

Third, the upgrade of the physical plant was largely (80 percent) complete by year-end 2002 and capital outlays dropped off dramatically in 2003.⁷⁰ Since penetra-

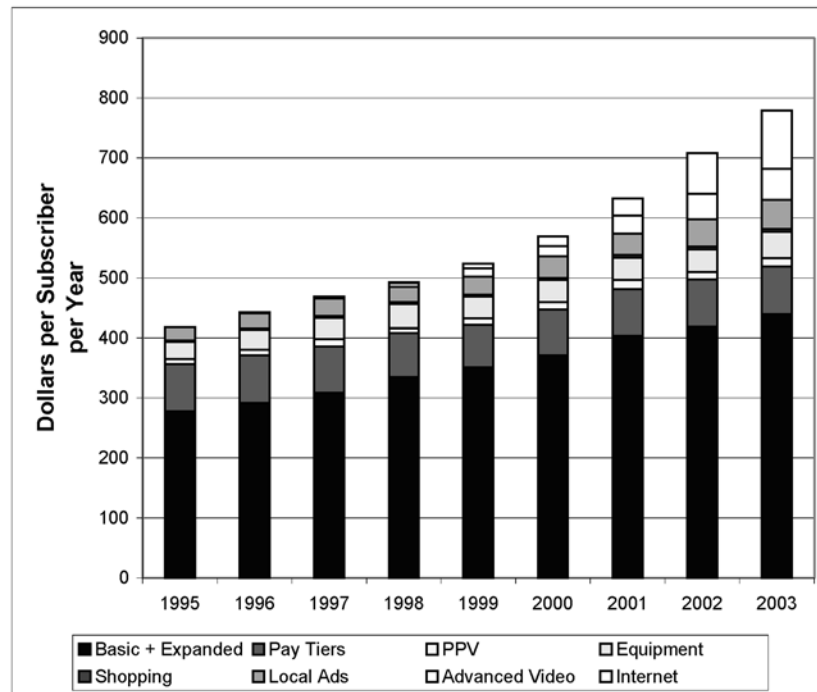
tion of high speed Internet is in its early stages, and advanced video services have not yet fully penetrated, cable operators are set to reap huge profits as advanced digital video and Internet services penetrate the market. In other words, capital costs are set to decline sharply, while revenues from the services that are supported by those capital costs are increasing sharply.

For the eight-year period (1995–2003), there has been a \$360 increase in revenues per subscriber per year (see Exhibit 6).⁷¹ Revenues per subscriber per year have almost doubled, while the number of subscribers has increased by 10 percent. There for total revenues in absolute value have more than doubled.⁷² The new services (advanced video and Internet and to a much lesser extent cable telephony) have come to play a large role in total revenue, projected to make up about one-fifth of the total in 2003. Operating cash flow per subscriber (operating revenues minus operating costs) increased by \$140 from 1995 to 2003. This is an increase of 77 percent per subscriber and 90 percent in absolute terms. This is cash flow that is available for capital service and excess profits.

2. Cash Flow for Traditional Video Services

The GAO cautions that it is difficult to apportion capital costs between the traditional video business and the new lines of business. The same is true with operating expenses. An expert for Cox recognizes the problem, but conveniently punts:

EXHIBIT 6: Increasing Revenues Per Subscriber



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4; Tenth Annual Report, Table 4.

In particular, it seems likely that a relatively large share of increased capital costs and perhaps also operating costs may have been incurred in order to permit firms to offer more advanced products than expanded basic service, such as digital tiers of service (including pay per view and video on demand), broadband Internet connections and telephony.

In my opinion, any attempt to allocate a portion of those cost increases to basic analog service (in order to determine if prices for expanded basic service have risen by more than would have been sufficient to cover all cost increases of expanded basic service) would require a long list of assumptions which would be open to question and controversy.⁷³

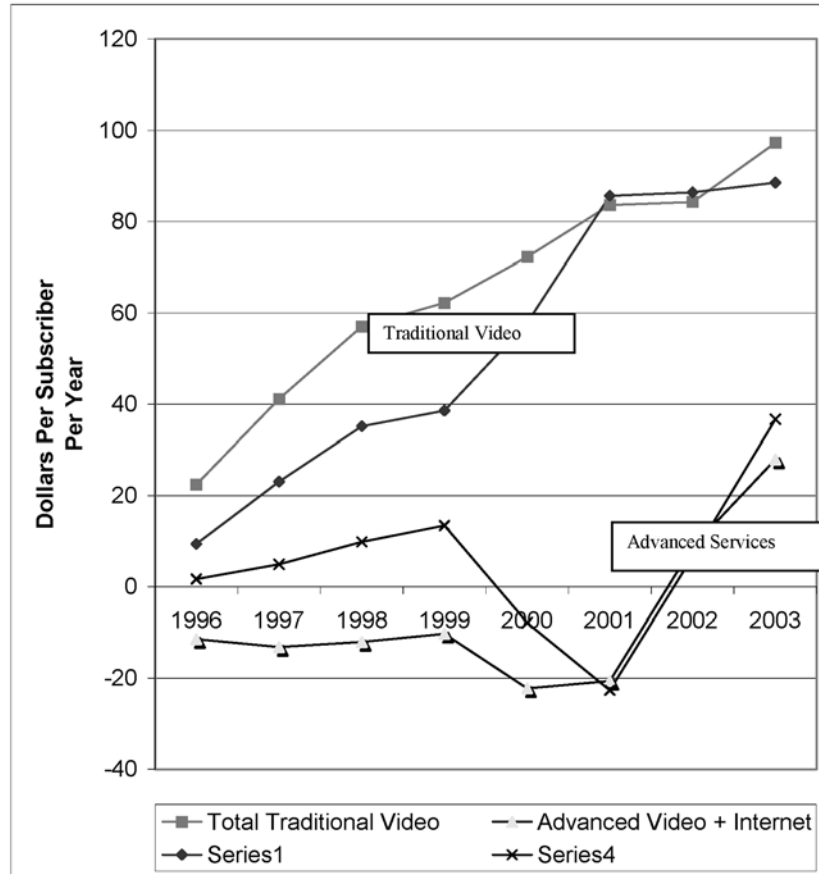
Considering a plausible scenario to assess the run-up in cash flow from traditional video businesses shows why the cable industry chooses not to show how much the cost of basic and expanded basic service have increased.⁷⁴ Between 1995 and 1998, before advanced video and Internet were being widely sold to the public, operating expenses increased by about 4.5 percent per year.⁷⁵ Between 1998 and 2002, operating costs increased by over 14 percent per year, more than three times the rate prior to the aggressive marketing of advanced and Internet services. There is good reason to believe that the increase in operating expenses was not due to traditional video services.

From 1995 to 1998, cable operators added 3.3 million basic subscribers, just about as many as they added from 1998 to 2002.⁷⁶ From 1995 to 1998, cable operators added 117 new advertiser supported cable networks, over 50 percent more such networks than they added from 1998 to 2002.⁷⁷ Thus a substantial expansion of subscribers and traditional video services occurred with modest increases in operating costs.

There is no doubt that after 1998, operating costs to support advanced video and Internet services increased sharply. One can argue that there was some increase in non-programming operating costs attributable to basic and expanded basic, but little of the capacity added to cable systems was devoted to that purpose. Full upgrades add the equivalent of 70 or more 6-megahertz channels, only 10 of which have been dedicated to basic and expanded basic tiers of service. A cautious approach shows the impact.

Exhibit 7 splits the cash flow into two streams. One stream is made up of traditional video (basic+expanded+pay tiers+pay per view+equipment+shopping+local advertising). The other stream is made up of advanced video and Internet. Operating cost increases have been apportioned under the following two sets of assumptions. All of the pre-1999 operating cost increases are attributed to traditional video. In one scenario, forty percent of the post-1999 operating cost increases is attributed to traditional video. This figure is suggested by an analysis prepared for ESPN, which estimates that the increase in programming costs in 1999 to 2002 was equal to 32 percent of the total increase in operating costs.⁷⁸ In the second scenario, the post-1999 increase is assumed to be 4.5 percent (the pre-1999 rate) plus \$1 additional each year for 2000–2003, which is the average annual increase in programming costs per subscriber in the 1999 to 2002 period. In both cases, the results are similar.

EXHIBIT 7: Cumulative Increases in Cash Flow Per Subscriber From Traditional and Advanced Cable Services



Source: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4; Seventh Annual Report, p. 102. Tenth Annual Report, Table 4. See text for assumptions.

Cash flow grew sharply from traditional video service through 2001 and then leveled out at a very high level. The leveling is due to a combination of increasing programming costs and continually mounting non-programming operating costs attributed to traditional video. Non-programming operating expenses for traditional video are not likely to continue to rise at the assumed rate, certainly not for traditional video services. Therefore, the increase in the cash flow is likely to be permanent. Cash flow from traditional services increased as a percentage of revenue from those services. Cash flow from advanced video and Internet services was slightly positive early. It became negative with the major roll out of Internet services, but became sharply positive in 2003.

The market structure and financial analysis in this section present a strong case that the conceptualization of the supply-side of the market in Exhibit 1 is correct. There is a continuing exercise of market power over traditional video services. Both the absolute size and the rate of profits on traditional video services appear to have increased over the period. In this sense, the consumer complaint about rising cable rates is fully justified.

III. The Demand-Side

If consumer surplus is also growing rapidly, however, then that might blunt the public policy concern. NCTA seeks to demonstrate that there was a substantial increase in consumer surplus by claiming that the real price of quality-adjusted service has declined. Thomas Hazlett makes a similar claim, based primarily on the growth of subscribers and channels.⁷⁹ In this section, I demonstrate that this basic claim is incorrect and the whole welfare improvement argument overstated.

A. Estimation of Quantity Adjusted Price Changes

The cable industry estimates involve a series of analytic errors of commission and omission and the general claims of increases in consumer welfare have several fundamental flaws. First, there is a misspecification of the units of analysis. Referring to Exhibit 1, the quantity of cable consumed (measured on the X-axis) is counted by NCTA as the total number of viewing hours. Since the X-axis is the total amount of consumption, the amount paid (measured on the Y-axis) should be the total amount paid for the products consumed. However, for the Y-axis in their welfare calculation, NCTA uses the BLS consumer price index for services. NCTA recognizes, however, *that the BLS index has already been adjusted downward for increases in the quantity of channels available and other factors*. Therefore, the NCTA double counts quantity changes. In the analysis below, I use the actual price paid for the total bundle of programs.⁸⁰

Second, NCTA chooses to start its analysis eighteen months after the passage of the Telecommunications Act of 1996, conveniently excluding eighteen months of the most rapid rate increases in the history of the industry. Third, there would also appear to be a mismatch between the estimate of increased viewing and the estimate of declining prices. Since viewing numbers are seasonal and January is roughly the mid-point of the season, I use January prices.⁸¹

The cable industry estimates that in the 1995/1996 season, the average cable household watched 23.4 hours of advertiser supported cable networks per week (see Exhibit 8). I estimate that in January 1996, which coincidentally is the month before the 1996 Telecommunications Act was signed, the average monthly bill was \$22.60. The average cost per weekly viewing hour to the consumer was \$.966. The cable industry estimates that in the 2002/2003 season, the average cable household watched 34.7 hours of advertiser supported cable networks per week. I estimate the average price in January 2003 to be \$41.60 per month. The average cost per weekly viewing hour was \$1.199. That is a nominal increase of 24 percent. Inflation over the period was 17.7 percent, so the real increase was 5.5 percent. This is a very different picture than the 15 percent decline that NCTA claims by double counting quality improvements.

EXHIBIT 8: Cost of Viewing, 1996 & 2003

Market Condition	Viewing Hours	Monthly Cost/ Cost	Cost/ Hour	Viewing Hour Nominal	Viewing Hour Real	
1/1/96 Noncompetitive	23.4	\$22.60	\$.966		\$.966	
1/1/03 Noncompetitive switching has full value	34.7	41.60	1.198		1.019	
						% Increase in Viewing Cost Nominal
1/1/96 Noncompetitive	23.4	\$22.60	\$.966			
1/1/03 Noncompetitive switching valued ½ at the margin	29.05	41.60	1.432			} 48.2
1/1/96 Noncompetitive	23.4	\$22.60	\$.966			
1/1/03 Noncompetitive switching valued ¼ at the margin	26.0	41.60	1.60			} 1.66
BLS INCREASE (1/1/96 to 1/1/03)			48.5			

Source: For hours of viewing, Cable TV Advertising, Weekly Viewing of Ad-Supported Cable per Cable Household, and Source: NCTA, Steven S., *Assessing Quality Adjusted Changes in the Real Price of Basic Cable Service*, attached to Comments of the National Cable Telecommunications Association, in Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 03-172, September 11, 2003, p. 12. Cable prices for noncompetitive systems from Federal Communications Commission, *Report on Cable Prices*, January 2, 1997, p. 12, May 7, 1999, p. 9; June 15, 2000, p. 9; Feb 14, 2001; 9; April 4, 2002, p. 8; July 8, 2003, p. 10; General Price increases from Bureau of Labor Statistics, Consumer Price Index.

B. Bundling, the Demand Curve and Consumer Surplus

These simple math problems are compounded by conceptual issues. Bundling is the central character in the current drama surrounding cable prices and this wreaks havoc with the NCTA estimate of consumer welfare. The failure of cable operators to offer cable channels on an unbundled basis makes it difficult to divine the demand curve for individual channels. NCTA mentions, in passing, that viewing is not evenly distributed, but that does not influence its calculation. NCTA assumes (or at least uses in every example and hypothetical case) that demand is linear and that elasticity does not change over time. Both of these assumptions are dubious at best. Cox assumes demand is linear, equal and uncorrelated across individual channels to work its example of consumer benefit from bundling.⁸² This, too, is dubious, at best.

At least Cox recognizes that there are conditions under which bundling results in consumer harm. The conditions are:

related to a firm's motivation to try to charge different consumers different prices for the same product depending upon what they are willing to pay for it. The essential idea is that when there is some negative correlation between individual consumers' valuation of different products, that firm can sometimes charge higher prices to everyone by bundling goods together.⁸³

Although Cox notes that: "it is easy to create examples where bundling can make consumers worse off but equally easy to create examples where bundling makes consumers better off," it ignores the problem.⁸⁴ Bundling demands greater attention.

Comcast's approach provides a useful starting point. It presents cable bundling as a greengrocer who sells tomatoes for \$2 per pound, but who might also sell five pounds for \$7.50. The tomatoes are cheaper on a per unit basis in the bundle (a

volume discount) although the total bill is greater. The fundamental problem is that greengrocers invariably give the consumer a wide range of choices. The consumer can buy half a pound of tomatoes, or three pounds, or take the five-pound discount, as his or her needs may dictate. Cable operators do not give consumers that much choice.

In fact, cable operators give consumers almost no choice. Essentially cable consumers have three choices—take nothing, take almost nothing (basic), or take almost everything (expanded basic). If I really need two pounds of tomatoes for my spaghetti sauce, I have to take all five pounds and most of the other fruits and vegetables, even though the rest of it is of little value to me.⁸⁵ My next door neighbor, who really needs two pounds of apples for her pie, is forced to buy five pounds of apples and the tomatoes and all the other fruits and vegetables, too. We both end up paying a higher price and, given the nature of the commodity, we cannot recapture the surplus through trade. It is conceivable that we could split the cost, but then I have to have my neighbors in my house all the time. If we buy one subscription and try to run a wire (or a wireless network) between our houses, the cable operators have us arrested for stealing their signal.

NCTA's welfare analysis assumes a full hour of increased welfare when a consumer shifts from watching a broadcast show to watching a cable show. That is, if a consumer watches a rerun of "Law and Order" on USA, instead of NBC, NCTA claims the full hour as an increase in the consumer's welfare. There may be little welfare gain. If the consumer had shifted from watching "West Wing" to watching "Law and Order," one could argue that there is a welfare gain, but it is only the marginal difference between the two. Because the shows are all forced into the bundle, we cannot tell what consumers would pay for them on a stand-alone basis.

If total hours of viewing had increased as much as cable viewing, the assumption that every hour watched on cable represents a full hour of gained consumer welfare would be more plausible, but that is not the case. The increase in total viewing is considerably less than the increase in cable viewing. In contrast to the 5.7 percent per year increase claimed by cable operators for viewing of advertiser supported cable networks, the FCC cites estimates of less than a 1.5 percent per year increase in viewing over a similar period,⁸⁶ while others show less than a one percent per year increase. A well respected industry source that estimates both total TV viewing hours and basic/expanded cable network viewing hours puts the total increase at 25 percent of the cable switching increase.⁸⁷ Even if we assume that the entirety of increased TV viewing occurred in cable households, we would still conclude that the net increase in viewing was equal to slightly over one-third of the total increase in cable network viewing.

If we assume that the actual increase in consumer welfare is equal to half the total increase in cable viewing (leaving some room for a marginal increase due to switching), the quality-adjusted cost would be \$1.432 (see Exhibit 8). The increase in the price over the 1996–2003 period would be 48 percent. Interestingly, the quantity and quality adjusted price as reported by the BLS increased by 49 percent over this period. If the increase in value in viewing were equal only to the increase in total viewing (*i.e.*, valued $\frac{1}{4}$ at the margin), the effective price increase would be 66 percent over this period, almost fifty percent higher.

The case against the BLS price index is not convincing. In fact, the BLS may be over-adjusting for quantity and quality because many channels are forced into the bundle that few people are watching. The top 10 cable programs account for 50 percent of all viewing that is significant enough to be registered by Nielsen. The top 20 shows account for 75 percent of all such viewing. The GAO reports that the typical household watches only 17 channels. People are being forced to buy a lot of shows they don't watch to get the ones they want. Although the bottom 30 shows that register on the Nielsen scale pass an average of just under 70 million homes, only about a quarter of a million households watch them during any given day. For every one household watching, approximately 250 who are forced to pay for it in the bundle are not. For the bottom two shows, the ratio is 1 to 800. Over 250 additional cable networks do not capture enough viewers to even register on the Nielsen scale.⁸⁸

A recent study by Deutsche Bank of the Cox-ESPN controversy reinforces the conclusion that bundling leads NCTA to overestimate the welfare gains (see Exhibit 9).⁸⁹ ESPN is one of the most popular and the most expensive cable networks, yet seventy-eight percent of respondents said that they would not pay \$2 per month for it if they were given the choice. Cox confirms this estimate, noting that less than a quarter of its subscribers are "avid sports fans."

There is good reason to believe that the elasticity of demand for ESPN alone is a lot higher than for the bundle and that the bundling of sports programming into the most popular package is harming consumers. The three-quarters of cable view-

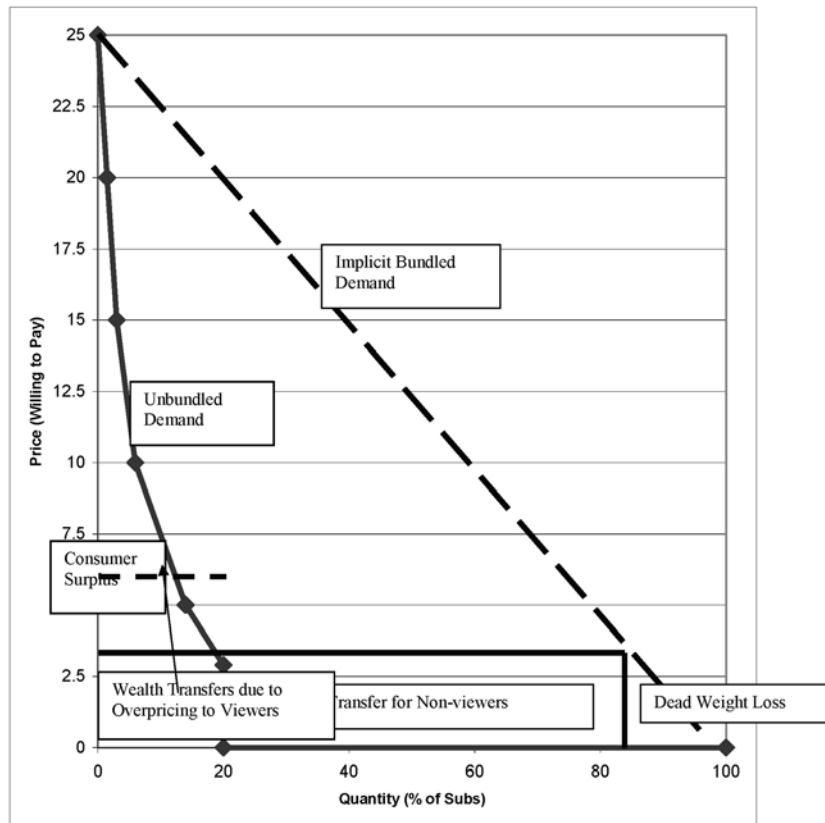
ers who say they would not pay \$2 dollars for ESPN, likely the three-quarters who are less than avid sports fans, are paying over \$1.5 billion for it in the bundle (at Cox's cost).⁹⁰ Exhibit 9 shows the wealth transfers and efficiency losses associated with ESPN. For every one dollar of consumer surplus, there is at least one dollar of wealth transfer. This does not include the wealth transfers associated with the overpricing of ESPN to those who would take it, which may equal another quarter of the consumer surplus. The deadweight efficiency losses are an additional cost associated with this anti-consumer bundling.

IV. Long-Term Trends

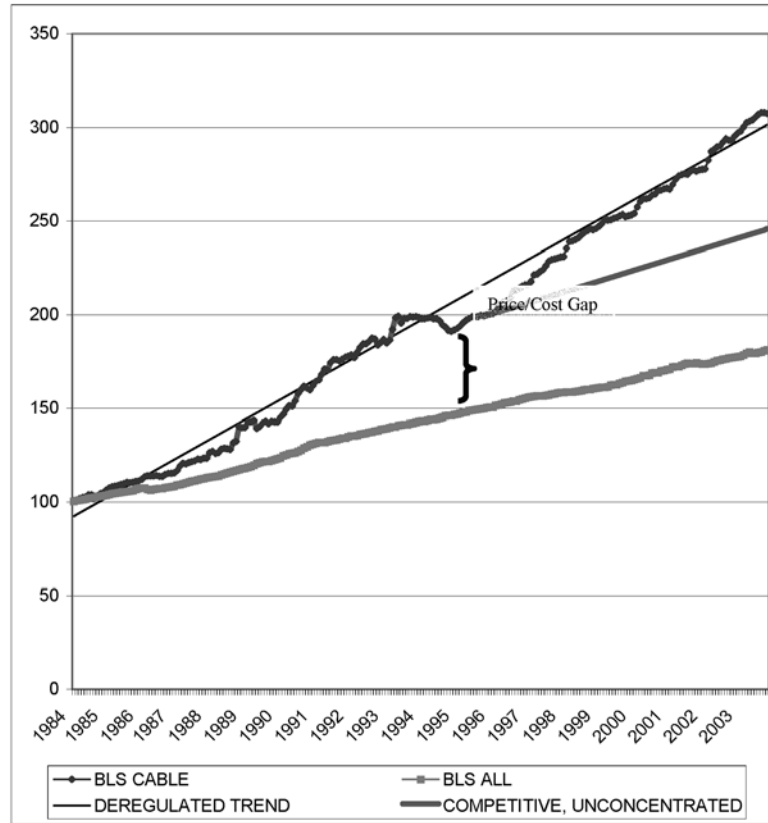
A. Price

NCTA's hours of viewing approach to consumer welfare analysis vastly overstates the gain in welfare and the BLS number of channels approach may well be overstating the quality adjustment. Given this conclusion, it is instructive to note the long-term trends of cable pricing. I have pointed out that the FCC was already being challenged to explain dramatic rate increases in the January 1997 report on cable pricing. In that report, the Commission reproduced a graph it had used to show that rate regulation in the 1993–1995 period had shielded consumers from price increases (see Exhibit 10). The trend line and the price line, extended through September 2003, show that the Commission had squeezed out a small part of the excess profits during the short period of rate regulation, but the 1996 Act launched the industry on a trajectory that not only recaptured what had been lost during the short period of partial regulation, but has gone beyond what it had been extracting in the past. This reaffirms the depiction in Exhibit 1.

EXHIBIT 9: Wealth Transfer and Consumer Surplus For ESPN



Source: Deutsche Bank, Walt Disney Company, October 27, 2003, p. 16.

EXHIBIT 10: Long Term Price Trends

Source: Bureau of Labor Statistics, CPI. Deregulated trend is a linear projections of January 1983-April 1993, Competitive, unconcentrated from Exhibit 15.

B. Quantity

The aggressive bundling of cable programming, across video tiers and now between video and non-video services, complicates the consumer welfare analysis enormously. The claim that regulation hurt consumers is simply wrong. The number of subscribers has grown virtually every year since the inception of the industry (see Exhibit 11).

A model that uses the long-term trend in income growth and price changes to predict cable subscribers explains 96 percent of the variance in cable growth. It suggests that cable subscription performed somewhat better than expected in the early-mid 1990, when rates were regulated momentarily, but somewhat worse than expected since rates were fully deregulated. Adding in competitive satellite (*i.e.*, the number of satellite subscribers who live in areas where cable is available)⁹¹ fills the gap somewhat, but at the end of the period, there are fewer households subscribing than projected. This is the deadweight inefficiency we would expect to see as a result of the aggressive price increases and bundling of recent years. It is exactly the opposite of what the cable industry experts claim.

V. Conclusion

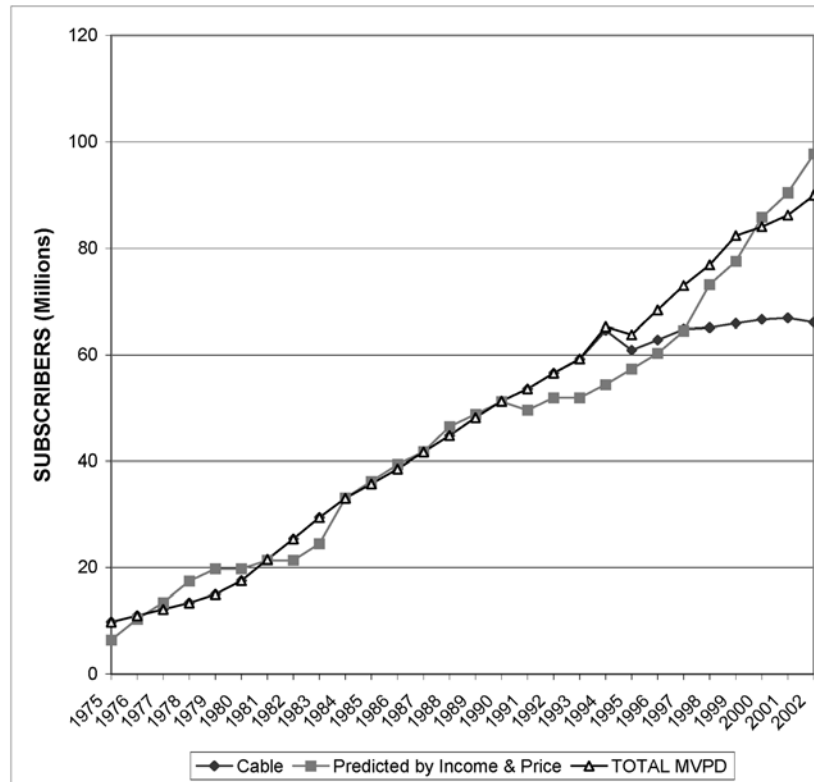
The basic comparison that consumer advocates have made to reflect the pain inflicted by cable operators—that cable prices have been rising at almost three times the rate of inflation—is a solid and proper way to state the problem. The complaint that prices are rising too fast is valid—reflected in the increasing cash flow thrown off from traditional video services. There is no doubt that consumers are being

harmful by a lack of effective competition for cable. That cable operators have ridden the wave of rising incomes and changing technologies does not demonstrate the positive quality of their pricing/bundling strategy. The claim that deregulation helps consumers because consumer welfare has increased begs the question of whether abuse of consumers has increased even more rapidly.

The possibility of anti-consumer bundling has long been recognized in the economics literature. The data suggests that cable operators have pushed prices into the range where there is price resistance (*i.e.*, the more elastic portion of the demand curve). That does not mean the abuse has stopped, it simply means it may not grow as quickly as in the past, but cable operators are aggressively finding ways to keep their producer surplus growing, like rebundling (retiering) programming to drive penetration of digital tiers.⁹² The recognition of the possibility of anticompetitive bundling in a dynamic or strategic sense is more recent, but no less important, especially as cable market power is “swung” into the high-speed Internet.⁹³

Bundling is one of the strategies that monopolists use to extract consumer surplus and the evidence is consistent with such an interpretation in this case. Public policy might attack bundling, but policy that controlled the rents directly would be preferable. Of course, real competition would be better still, but after two decades of failure of competition to develop and with the cable operators extending the anti-competitive, anti-consumer business model to the Internet, the need for action is critical.

EXHIBIT 11: Income Growth as a Predictor of Cable Subscription



Sources: Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Tenth Annual Report, January 5, 2004, Table 1; Ninth Annual Report, December 2002, Table B-1; Sixth Annual Report, Table C-1; for 1995 through 2002; Paul Kagan Associates, *History of Cable TV Subscribers and Revenues*, 1997, for pre-1995; Income is real, per capita disposable income from *Economic Report of the President* (February 2003), p. 313.

APPENDIX B

TOP RATED CABLE CHANNELS: THEN AND NOW

COMPILED BY FEDERAL COMMUNICATIONS COMMISSION

ANNUAL CABLE COMPETITION REPORT

Network	1996 Ranking (Primetime)	2003 Ranking (Primetime)
A&E	7	8
Cartoon Network	6	6
Discovery	9	10
ESPN	3	14
Lifetime	5	2
Sci-Fi Channel	14	15
TBS	2	5
The Learning Channel	12	12
The Nashville Network (Spike TV)	10	13
TNT	1	1
USA Network	4	7

Channels that moved into Top 15 after 1996	
Disney Fox News	MTV Nickelodeon

Sources: Federal Communications Commission, MB Docket No. 03-172, Third Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming at 180.
Paul Kagan Associates, Cable TV Programming, Prime-Time Ratings, July 1996, at 10.
Kagan World Media, *Day Part Ratings Averages, Prime Time (July)*, Cable Program Investor, Sept. 12, 2003, at 16.

APPENDIX C

THE TOP CABLE CHANNELS

BY NUMBER OF SUBSCRIBERS AND PRIMETIME RATINGS

COMPILED BY FEDERAL COMMUNICATIONS COMMISSION

FOR TENTH ANNUAL CABLE COMPETITION REPORT—JANUARY 5, 2004

	Owners (Independent in <i>Italics</i>)
<i>ABC Family</i>	<i>Disney—ABC</i>
<i>AMC</i>	Cablevision
<i>A&E</i>	Disney—ABC/General Electric—NBC/Hearst
<i>Cartoon Network</i>	Time Warner—WB
<i>CNBC</i>	General Electric—NBC
<i>CNN</i>	Time Warner—WB
<i>C-SPAN</i>	Cable Consortium
<i>Discovery</i>	Liberty Media—Fox/Cox Cable
<i>Disney Channel</i>	Disney—ABC
<i>ESPN</i>	Disney—ABC

	Owners (Independent in Italics)
<i>ESPN2</i>	Disney—ABC
<i>Fox News</i>	NewsCorp—Fox
<i>Lifetime</i>	Disney—ABC/Hearst
<i>MTV</i>	Viacom—CBS
<i>Nickelodeon</i>	Viacom—CBS
<i>QVC</i>	Liberty Media—Fox/Comcast Cable
<i>Sci-Fi</i>	General Electric—NBC *
<i>Spike TV (TNN)</i>	Viacom—CBS
<i>TBS</i>	Time Warner—WB
<i>The Weather Channel</i>	Landmark Communications
<i>TLC</i>	Liberty Media—Fox/Cox Cable
<i>TNT</i>	Time Warner—WB
<i>USA Network</i>	General Electric—NBC*
<i>VH1</i>	Viacom—CBS

* If General Electric/Universal merger is approved as pending
Sources:
Federal Communications Commission, MB Docket No. 03–172, Tenth Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming at 141–142.
NCTA, *Top 20 Cable Networks*, Cable Developments 2003, at 39–40.
Kagan World Media, *Day Part Ratings Averages, Prime Time (July)*, Cable Program Investor, Sept. 12, 2003, at 16.

APPENDIX D

EXAMPLES OF INDEPENDENT CABLE CHANNELS

COMPILED BY FEDERAL COMMUNICATIONS COMMISSION

FOR TENTH ANNUAL CABLE COMPETITION REPORT—JANUARY 5, 2004

Cable Network	Owners
ACNTV (America's Collectibles Network)	America's Collectibles Network
ANA Television	Middle East Broadcasting Centre (MBC)
ART (Arab Radio & Television)	Arab Media Corporation
Bloomberg Television	Bloomberg L.P.
B Mania	B Mania Television Network
Canal SUR	Canal SUR (Latin American and Mexican TV)
China Central Television	State Administration of Radio, Television, and Film—People's Republic of China
Church Channel	Trinity Broadcasting Network
Classic Arts Showcase	The Lloyd E. Rigler—Lawrence E. Deutsch Foundation
CSTV (College Sports Television)	College Sports Television
Deep Dish TV	Deep Dish TV
Destiny Channel	Destiny Channel
Do-It-Yourself Channel	Scripps
Dream TV Network	Dreamland Development—Egypt
ETWN: Global Catholic Network	Eternal World Television Network
FamilyNet	Southern Baptist Convention

Cable Network	Owners
Filipino Channel	ABS-CBN
Fine Living	Scripps
Food Network	Jones Media Networks
Free Speech TV (FSTV)	Free Speech TV
Galavision	Univision
GolTV	Tenfield—Uruguay
Golden Eagle Broadcasting	Oral Roberts University
Goodlife Television Network	Nostalgia Network, Inc.
HDNet	HDNet
HDNet Movies	HDNet
HGTV (Home and Garden Television)	Scripps
Horse Racing TV	Magna Entertainment Corp.
HSN America's Store (Home Shopping Network)	IAC/InterActiveCorp
HTV	ITV1 West of Wales
Inspirational Life Television (I-LIFETV)	Inspiration Networks
Inspirational Network (INSP)	Inspiration Networks
JCTV	Trinity Broadcasting Network
La Familia Network	Inspiration Networks
Liberty Channel	Jerry Falwell Ministries
Locomotion Channel	Corus Entertainment/Hearst Corporation
MBC Network	MBC Network
MBC America	MUNHWA Broadcasting Corporation
Mun2	Mun2
NASA Television	National Aeronautics and Space Administration
National Jewish Television	Hineni International
Oasis TV	Oasis TV
TBN	Trinity Broadcasting Network
UBC	Urban Broadcasting Company
Univision	Univision
Video Rola	Entretenimiento Satelital
Weather Channel	Landmark Communications
WGN	Tribune Company

Endnotes

¹ Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 03–172.

² U.S. General Accounting Office (U.S. GAO), *Issues Related to Competition and Subscriber Rates in the Cable Television Industry*, October 2003; *Telecommunications: Issues in Providing Cable and Satellite Television Service*, October 15, 2003.

³ Fabrikant, Geraldine and Bill Carter, “Cable’s New Giant Flexes His Muscles,” *New York Times*, October 20, 2003; “Testimony of James O. Robbins,” *Senate Commerce Committee*, May 6, 2003.

⁴ Eisenach, Jeffrey A. and Douglas A. Truehart, *Rising Cable Rates: Are Programming Costs the Villain?*, supported by ESPN, Inc., October 23, 2003 (hereafter ESPN); Economists Inc., *Consumer, Operator, and Programmer Benefits from Bundling Cable Networks*, July 2002; Rogerson, William P., *Cable Program Tiering: A Decision Best and Properly Made by Cable System Operators, Not Government Regulators*, November 10, 2003, funded by Cox (hereafter Cox); *Correcting the Errors in the ESPN/CAP Analysis Study on Programming Cost Increases*, November 11, 2003, prepared for Cox Communications (Cox II).

⁵ Katz, Michael, *An Economic Analysis of the Claims made by Dr. Mark Cooper in “Cable Mergers, Monopoly Power and Price Increases,”* Commissioned by Comcast Corporation, July 28, 2003 (hereafter Comcast). The target of the Comcast paper is a short study prepared in January 2003 entitled *Cable Mergers, Monopoly Power and Price Increases* (Washington, DC: Consumer Federation of America and Consumers Union, January 2003). This critique ignores several much longer documents including Consumer Federation of America, “Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, The Office of Communications of the United Church of Christ, Inc., National Association of Telecommunications Officers and Advisors, Association for Independent Video Filmmakers, National Alliance for Media Arts and Culture, and the Alliance for Community Media,” 2002; and “Reply Comments of the Consumer Federation of America, Consumers Union, Center for Digital Democracy, and Media Access Project,” 2003; Federal Communications Commission, *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission’s Cable Horizontal and Vertical Ownership Limits and Attribution Rules, Review of the Commission’s Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission’s Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission’s Cross-Interest Policy*, CS Docket No. 98–82, CS Docket No. 96–85, MM Docket No. 92–264, MM Docket No. 94–150, MM Docket No. 92–51, MM Docket No. 87–154; and Cooper, Mark, *Cable Mergers and Monopolies: Market Power in Digital Communications Networks* (Economic Policy Institute, 2002).

⁶ Wildman, Steven S., *Assessing Quality Adjusted Changes in the Real Price of Basic Cable Service*, attached to Comments of the National Cable Telecommunications Association, in Federal Communications Commission, *In Re: The Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 03–172, September 11, 2003 (hereafter NCTA).

⁷ Federal Communications Commission, *Tenth Annual Report (In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming)* Washington, DC, January 28, 2004 (hereafter Tenth Annual Report).

⁸ “Testimony of Gene Kimmelman,” *Senate Commerce Committee*, May 6, 2003, cited in ESPN, p. 4.

⁹ *Tenth Annual Report*, para. 10.

¹⁰ *Tenth Annual Report*, para 139.

¹¹ 1A *Tenth Annual Report*, para 30.

¹² *Tenth Annual Report*, para 31.

¹³ *Tenth Annual Report*, note 73.

¹⁴ *Tenth Annual Report*, note 203.

¹⁵ *Tenth Annual Report*, Table 4.

¹⁶ *Tenth Annual Report*, footnote 11.

¹⁷ *Tenth Annual Report*, para. 140.

¹⁸ Cooper, Mark, *Media Ownership Democracy in the Digital Information Age* (Stanford: Center for Internet and Society, 2003), Chapter 6.

¹⁹ *Tenth Annual Report*, para. 136.

²⁰ *Tenth Annual Report*, para 130–132.

²¹ See *Tenth Annual Report*, Table B–1.

²² Compare *Tenth Annual Report*, para 41 and 65.

²³Joint Statement of Commissioners Michael J. Copps and Jonathan S. Adelstein, *Concurring* January 28, 2004.

²⁴The only evidence that the industry paper gives on market power is provided by Comcast, which points to one indicator of market power, Tobin's q (the system sales price in comparison to the reproduction cost). Citing numbers from the Federal Communications Commission, *Ninth Annual Report, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, MB Docket No. 92-145, December 31, 2002, p. 16), Comcast points out that (p. 19): the "National Average Dollar Value Per Subscriber *declined* dramatically, falling from a peak of \$5755 in 2000 to \$2196 in January through June 2002." This statement fails to take into account the dramatic difference in the nature of the systems being transacted. The average number of subscribers transacted in the peak year Comcast cited was over 250,000 per system in 45 transactions for a total of over \$66 billion. The average number of subscribers in the first half of 2002 was only 32,000 in 12 transactions for a total of less than \$1 billion. If we compare small systems transacted in 2000 to the small systems transacted in 2002, we get a very different picture; see Federal Communications Commission, *Seventh Annual Report, In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, CS Docket No. 00-132, January 8, 2001, Table C-5. For example, there were 39 transactions in 2000 for systems with fewer than 100,000 subscribers. The average system price was approximately \$2,666 per subscriber. Thus, the system price has declined by about 18 percent, which is modest compared to the stock market declines (see Couper, Elise A, John P. Hejkal, and Alexander L. Wolman, "Boom and Bust In Telecommunications," *Economic Quarterly*, Fall 2003. The analysis also does not account for a decline in the reproduction costs, was also evident.

²⁵Comcast, p. 14, states the proposition as follows: "As long as the increase in the monthly fee is less than the amount by which consumers value the new programming, they will be better off at the new 'higher' price coupled with the additional programs."

²⁶Scherer, F. M. and David Ross, *Industrial Market Structure and Economic Performance* (Boston: Houghton Mifflin, 1990), pp. 21-29.

²⁷Comcast, pp. 12-13; Cox, Appendix, uses this model as well.

²⁸Industry defenders frequently claim that rising prices cannot be caused by market power, since in frictionless theory the monopolist would immediately ascertain his profit-maximizing price and charge it (Comcast p. 14, Hazlett, Thomas, *Cable TV: Has Deregulation Failed?*, Manhattan Institute for Policy Research, November 21, 2003). Reality, of course is more complicated than that. Monopolists price politically, searching for what they can get away with before they evoke a reaction, especially in an industry whose rapacious behavior caused it to be reregulated once.

²⁹Cox, Appendix, argues that allowing the monopolist to reallocate rents from programmers will increase its rate of profit as well as consumer welfare under some circumstances.

³⁰U.S. GAO, 2003, Appendix IV.

³¹U.S. GAO, 2002.

³²*Tenth Annual Report*, para. 83, citing *First Annual Report*, para. 57.

³³Federal Communications Commission, *Report on Cable Prices*, April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

³⁴*Tenth annual Report*, para. 16.

³⁵I assume that 98 percent of cable subscribers lack head-to-head competition (Federal Communications Commission, *In the Matter of the Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming: Ninth Annual Report*, MB Docket No. 02-145, December 31, 2002, para. 115) and 90 percent of those take expanded basic service (ESPN, p. 2). Therefore, 62 million cable households are the victims of abuse of market power. Their bills could be reduced by \$8 per month as a result of genuine head-to-head competition and deconcentration of the industry.

³⁶U.S. GAO, 2003, Appendix IV.

³⁷FCC, *Report on Cable Prices*, April 4, 2002, Attachment D-1; February 14, 2001, Attachment D-1; June 2000, Attachment D-1; May 7, 1999, C-1.

³⁸FCC, *Report on Cable Prices*, February 14, 2001, Attachment D-1; June 2000, Attachment D-1.

³⁹*Tenth Annual Report*, para 132. Comcast once again has failed to notice the consistent empirical evidence that finds size and clustering increase prices, contradicting their claim that (pp. 18-19) "there is no reason to think that consolidation of cable ownership at the national level will affect actual competition among cable system operators. Ironically, cable industry experts find that mergers of some mo-

nopolists matter (John B. Hayes, Jith Jayaratne, and Michael L. Katz, *An Empirical Analysis of the Footprint Effects of Mergers Between Large ILECS*, April 1, 1999, p. 1; citing “Declaration of Michael L. Katz and Steven C. Salop,” submitted as an attachment to *Petition to Deny of Spring Communications Company L.P.*, in *Ameritech Corp. and SBC Communications, Inc., for Consent to Transfer of Control*, CC Dkt. No. 98–141 (filed Oct. 15, 1998) and *Petition to Deny of Spring Communications Company L.P.*, in *GTE Corporation and Bell Atlantic Corporation for Consent to Transfer of Control*, CC Docket. No. 98–184 (filed Nov. 23, 1998)) and that size and alternative distribution opportunities affect bargaining (see Rogerson, William P. “A Further Economic Analysis of the News Corp. Takeover of DirecTV,” *In the Matter of General Motors Corporation, Hughes Electronics Corporation, and the News Corporation Limited Application to Transfer Control of FCC Authorizations and Licenses Held by Hughes Electronics Corporation to the News Corporation Limited*, MB Docket NO. 03–124, August 4, 2003).

⁴⁰ Cooper, 2002, Chapter 7.

⁴¹ U.S. GAO, 2003, Appendix IV.

⁴² FCC, *Report on Cable Prices*, April 4, 2002, Attachment D–1.

⁴³ Cooper, 2002, pp. 21–32.

⁴⁴ See Cooper, 2002, pp. 44–47.

⁴⁵ Fabricant and Carter.

⁴⁶ Cox, Appendix A shows cable profits rising as programming costs fall.

⁴⁷ “Comments of the Consumer Federation of America, et al., *In the Matter of Implementation of Section 11 of the Cable Television Consumer Protection and Competition Act of 1992, Implementation of Cable Act Reform Provisions of the Telecommunications Act of 1996, The Commission’s Cable Horizontal and Vertical Ownership Limits and Attribution Rules, Review of the Commission’s Regulations Governing Attribution of Broadcast and Cable/MDS Interests, Review of the Commission’s Regulations and Policies Affecting Investment in the Broadcast Industry, Reexamination of the Commission’s Cross-Interest Policy*, CS Docket No. 98–82, CS Docket No. 96–85, MM Docket No. 92–264, MM Docket No. 94–150, MM Docket No. 92–51, MM Docket No. 87–154

⁴⁸ U.S. GAO, 2003, p. 27.

⁴⁹ ESPN, p. 9.

⁵⁰ Cox criticizes ESPN for comparing current revenues to total capital, a criticism that applies to Comcast even more forcefully, since ESPN at least reports annualized increases in debt costs, whereas Comcast provides no similar calculation. ESPN/s reporting of debt service misses the point, however, since part of the debt was incurred to fund acquisitions, not capital expenditures.

⁵¹ Only a consent decree forced Time Warner to allow modest access, and intense scrutiny forced AT&T to make some minor concessions, but the recent AOL/AT&T carriage agreement is thoroughly anticompetitive. “A New Model for AOL May Influence Cable’s Future,” *New York Times*, August 26, 2002, p. C1; Gilmore, Dan, “AOL Capitulates, Gives Up Struggle for ‘Open Access,’” *San Jose Mercury News*, September 1, 2002.

⁵² Cooper, Mark, “Open Access to the Broadband Internet: Technical and Economic Discrimination in Closed, Proprietary Networks,” 71 *University of Colorado Law Review*, 71: 2000.

⁵³ Federal Communications Commission, *High-Speed Service for Internet Access: Status as of June 30, 2003*, December 2003, Table 4.

⁵⁴ “A New Model for AOL May Influence Cable’s Future,” *New York Times*, August 26, 2002, p. C.1; Gilmore, Dan, “AOL Capitulates, Gives Up Struggle for ‘Open Access,’” *San Jose Mercury News*, September 1, 2002.

⁵⁵ Hu, Jim, “AOL’s Unrequited Cable Love,” *CNET News.com*, January 26, 2004.

⁵⁶ Latour, Almar and Peter Grant, “Verizon May Set Off Price War,” *Wall Street Journal*, May 5, 2003.

⁵⁷ *U.S. Department of Justice v. AT&T Corp and MediaOne Group, Inc.*, May 26, 2000.

⁵⁸ Conquering the high-speed Internet access as a neighbor market of video has additional advantages in preserving market power in the primary market (see for example, Carlton, Dennis W. and Michael Waldman, “The Strategic Use of Tying to Preserve and Create Market Power in Evolving Industry,” *Rand Journal of Economics*, Summer, 2002; Rubinfeld, Daniel L. and Hal J. Singer, *Open Access to Broadband Networks: A Case Study of the AOL/Time Warner Merger*, 16 Berkeley Tech. L.J. 631, 2001; Ordovery, Lansuz A. and Robert D. Willig, “Access and Bundling in High Technology Markets,” in Jeffrey A. Eisenach and Thomas M. Lenard (eds.), *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Washington, D.C.: Progress and Freedom Foundation, 1999); Salop, Steven C., “Using Leverage to Preserve Monopoly,” in Jeffrey A. Eisenach

and Thomas M. Lenard (eds.), *Competition, Innovation And The Microsoft Monopoly: Antitrust And The Digital Marketplace* (Washington, D.C.: Progress and Freedom Foundation, 1999). Bundling basic video with Internet access has the effect of undermining competition for video services (by driving basic into households and reducing the value of satellite). Bundling video content with Internet access reduces competition for video services, (See, e.g., Comments of the Competitive Broadband Coalition, *Implementation of the Cable Television Consumer Protection and Competition Act of 1992*, Cable Services Bureau Dkt. No. 01–290, at 10–11 [Dec. 3, 2001]). Bundling also raises barriers to entry by forcing competitors to build larger packages to compete: “AT&T is refusing to sell HITS to any company using DSL technology to deliver video services over existing phone lines because such companies would directly compete with AT&T’s entry into the local telephone market using both its own cable systems and the cable plant of unaffiliated cable operators. AT&T simply does not want any terrestrial based competition by other broadband networks capable of providing bundled video, voice and data services.” (Comments of the American Cable Association In the Matter of: Implementation of the Cable Television Consumer Protection and Competition Act of 1992, Development of Competition in Video Programming Distribution: Section 628(c)(5) of the Communications Act: Sunset of Exclusive Contract Prohibition, CS Docket No. 01–290 [filed Dec. 3, 2001]).

⁵⁹“Initial Comments of the California ISP Association, Inc.,” *Further Notice of Proposed Rulemaking in the Matter of the Computer III Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review—Review of Computer II and ONA Safeguards and Requirements*, Federal Communications Commission, CC Docket No. 95–20, 98–10, DA 01–620, April 16, 2001 (hereafter CISP, 2001a), p. 7; “Comments of DirecTV Broadband, Inc.,” *In the Matter of Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Universal Service Obligations of Broadband Providers, Computer III Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review—Review of Computer II and ONA Safeguards and Requirements*, Federal Communications Commission, CC Docket No. 02–33, 95–20, 98–10, May 3, 2002, p. 5; “Comments of Cbeyond, et al.,” *In the Matter of Appropriate Framework for Broadband Access to the Internet Over Wireline Facilities, Universal Service Obligations of Broadband Providers, Computer III Remand Proceedings: Bell Operating Company Provision of Enhanced Services; 1998 Biennial Regulatory Review—Review of Computer II and ONA Safeguards and Requirements*, Federal Communications Commission, CC Docket No. 02–33, 95–20, 98–10, May 3, 2002 (Hereafter Cbeyond, et al., 2002), pp. 27–28.

⁶⁰National Research Council report entitled *Broadband: Bringing Home the Bits*, (Washington, D.C.: National Academy Press, 2002), pp. 21, 152–154.

⁶¹Federal Communications Commission, High-Speed Services for Internet Access, June 2003, Tables 1, 2; Local Telephone Competition: Status as of December 31, 2002, June 2003, Tables 1, 13; NCTA, Overview 2003: Mid-Year, p. 1.

⁶²Young, Shawn and Peter Grant, “How Phone Firms Lost to Cable in Consumer Broadband Battle,” *Wall Street Journal*, March 13, 2003.

⁶³“Comments of Ad Hoc Telecommunications Users Committee,” *In the Matter of Review of Regulatory Requirements for Incumbent LEC Broadband Telecommunications Services*, Federal Communications Commission, CC Docket No. 01–337, March 1, 2002, pp. 18–19.

Cable modem service presents serious security and reliability issues that, while present for residential users, are of far greater concern when used to support business applications . . . In addition, service quality for cable modem service not equivalent to ILEC standards . . . Additionally cable modem transmission speeds are not consistent, due to the “shared platform” architecture . . . Finally, cable modem platforms do not offer business customers a sufficient level of security

⁶⁴Cable modem service presents serious security and reliability issues that, while present for residential users, are of far greater concern when used to support business applications . . . In addition, service quality for cable modem service is not equivalent to ILEC standards . . . Additionally cable modem transmission speeds are not consistent, due to the “shared platform” architecture . . . Finally, cable modem platforms do not offer business customers a sufficient level of security.

⁶⁵Kuhl, Craig, “Writing the Business Case for VDSL,” *CED*, April 2000. Extensive documentation of the technology difference is provided in Cooper, Mark, *Transforming the Information Superhighway into a Private Toll Road* (Washington, DC: Consumer Federation of America, October 1999).

⁶⁶ Hazlett, Thomas W. and George Bittlingmayer. *The Political Economy of Cable "Open Access."* Joint Center, Working Paper 01-06, May, argue that there is a strategic under allocation of capacity to high-speed Internet.

⁶⁷ Cox, Comcast and ESPN also focus on a short time frame.

⁶⁸ Federal Communications Commission, *Report on Cable Prices*, In the Matter of Implementation of Section 3 of the Cable Television Consumer Protection Act of 1992, Statistical Report on Average Rates for Basic Service, Cable Programming and Equipment, MM Docket No. 92-226, January 2, 1997, p. 7.

⁶⁹ *Id.*, p. 7.

⁷⁰ U.S. GAO, 2003, p. 26.

⁷¹ Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table B-7; Ninth Annual Report, December 2002, Table 4.

⁷² I report both revenue per subscriber and the total revenue because some costs are not incurred on a per subscriber basis.

⁷³ Cox II, p. 8.

⁷⁴ The GAO cautions that it is difficult to apportion capital costs between the traditional video business and the new lines of business. The same is true with operating expenses. The expert for Cox, recognizes the problem, but conveniently punts. Cox II, p. 8.

In particular, it seems likely that a relatively large share of increased capital costs and perhaps also operating costs may have been incurred in order to permit firms to offer more advanced products than expanded basic service, such as digital tiers of service (including pay per view and video on demand), broadband Internet connections and telephony.

In my opinion, any attempt to allocate a portion of those costs increases to basic analog service (in order to determine if prices for expanded basic service have risen by more than would have been sufficient to cover all cost increases of expanded basic service) would require a long list of assumptions which would be open to question and controversy.

⁷⁵ Federal Communications Commission, *Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming*, Ninth Annual Report, p. 15; Seventh Annual Report; NCTA, *Cable Pricing: Value and Cost*, May 2003.

⁷⁶ Federal Communications Commission, *In the Matter of Annual Assessment of the Status of Competition in Markets for the Delivery of Video Programming*, Fifth Annual Report, December 23, 1998, Table C-1; Ninth Annual Report, December 2002, Table B-1.

⁷⁷ NCTA, Overview 2003: Mid-Year, p. 12.

⁷⁸ ESPN, p. 12.

⁷⁹ Hazlett.

⁸⁰ Thinking about the cost of viewing to the public leads to another conceptual problem in the NCTA and Comcast analyses, one that has been recently highlighted by the ESPN analysis. ESPN points out they improve quality and increase audiences to increase their ability to sell advertising, as well as get more subscription revenues. Cox II, p. 6, nets advertising out from the cost of programming cable operators incur. That may make sense from the cable operator point of view, but not necessarily from the consumer point of view. Consumers have to watch the commercials and, ultimately, the cost turns up in the goods and services they buy. From a total social welfare analysis, the cost of advertising needs to be attributed to the cost of the total viewing time. The advertising revenue can be handled in a variety of ways, but it cannot be ignored.

⁸¹ Unfortunately, in 1996 the FCC shifted from a January cable price to a June cable price in its annual reports on cable prices. However, we can use the CPI to interpolate from June to January and only slightly underestimate the actual price increase (since quality adjustments over any short six month period are relatively minor). To the extent the industry was adding channels, this approach underestimates the price increase.

⁸² Cox, Appendix.

⁸³ Cox, p. 13.

⁸⁴ Cox, p. 13,

since regulation is costly and can create other distortions, the fact that this type of bundling cannot be shown to be systematically harmful to consumers is sufficient reason for most economists to conclude that there is no reason to regulate this type of bundling.

⁸⁵ The example offered by Cox assumes that all fruits and vegetables are equally valuable to consumers in exactly the same quantities.

⁸⁶Levy, Jonathan, Marcelino Ford-Levine and Anne Levine, *Broadcast Television: Survivor in a Sea of Competition* (Federal Communications Commission, OPP Working Paper, September 2002), p. 62; Albararan, Alan and Angel Arrese, "Time and Media Markets: An Introduction," in Albararan and Arrese (Eds.), *Time and Media Markets* (Mahwah, NJ: Lawrence Earlbaum Associates, 2003), p. 2.

⁸⁷Veronis Suchler Stevenson, *Communications Industry Report: Forecast Summary, 2003*, p. 48.

⁸⁸The explanations that cable industry executives gave the GAO for the social welfare superiority of bundling assume that advertisers irrationally pay for homes passed, rather than eyeballs watching, and that consumers maximize their welfare by subsidizing their neighbor's viewing habits. Those claims are inconsistent with the data in this paper (U.S. GAO, 2003, pp. 34–37).

⁸⁹Deutsche Bank, *Walt Disney Company*, October 27, 2003.

⁹⁰This assumes that the non-avid sports fans would pay nothing for it, given the choice.

⁹¹Cooper, 2002, pp. 26–32.

⁹²USPIRG, *The Failure of Cable Deregulation: A Blueprint for Creating a Competitive, Pro-consumer Cable Television Marketplace* (August 2003), pp. 18–19.

⁹³Carlton and Waldman.

The CHAIRMAN. Thank you very much, Mr. Kimmelman. The Honorable Marilyn Praisner of Montgomery County Council, welcome.

**STATEMENT OF HON. MARILYN PRAISNER, CHAIR,
TELECOMMUNITY AND CHAIR, NATIONAL ASSOCIATION OF
COUNTIES' TELECOMMUNICATIONS AND TECHNOLOGY
STEERING COMMITTEE**

Ms. PRAISNER. Thank you very much, Mr. Chairman, and thank you very much for including local government in this panel this morning. We very much appreciate the opportunity. Local governments have for a long time been eager and anxious for our constituents to have the benefits of every technology that's available, including especially, of course, because of the long-standing relationship, cable systems. We are anxious to have multiple providers in our communities.

As was said, I'm testifying today as Chair of TeleCommUnity and the National Association of Counties' Telecommunications and Technology Steering Committee. TeleCommUnity is an alliance of individual local governments and their associations which seek to focus attention in Washington on the principles of federalism and comity for local government interests in telecommunications, and I believe you're familiar with NACO, the association of the Nation's 3,000-plus counties in this country.

You have my written testimony and I'll only make a couple of comments. Number one, local governments agree with you that only real competition creates downward pressure on rates, and real competition for cable exists when a second wire line provider is present.

Two, we believe FCC actions have frustrated local rate regulation efforts and that some work is necessary in that area. And number three, à la carte pricing as an additional choice for consumers may be an improvement over the current tier pricing system if it provides consumers direct control and choice over the channels they buy and avoids price manipulation by the cable operator, and we believe it warrants further study.

My personal experiences are similar to those that were cited by the Honorable Chairman this morning with his communications

and those that I'm sure you're getting from your constituents who are also the constituents of my colleagues across this country. Consumers are complaining about the cable operators' annual rate increases greater than the local rate of inflation. They're complaining about cable services moved between tiers with little or no explanation or notice. They're complaining about bundling of cable modem and video services, which discourage DSL competition, and they're complaining about being forced to pay for digital converters to buy pay-per-view and pay channels. They claim that they are not offered the lowest available prices or accurate descriptions of their purchasing options when they call the company.

Most of these problems, we believe, are caused by lack of effective competition. Without wire line competition, cable rates and these frustrations will continue to rise. On the issue of DBS, we believe DBS does not constrain cable rates. It is not a true competitive alternative for major television market cable customers. Equipment is not interchangeable, it does not offer two-way high-speed data services comparable to cable model, it doesn't always offer local broadcast signals, and it cannot carry the very important to us local public, educational, and government access programming.

Competitive broadband providers including cable system overbuilders have complained to us of incumbent cable operators using aggressive marketing tactics to drive these small competitors out of the market. We believe any legislation to respond to escalating cable rates should include encouragement of wire line competition and protection of competitors' access.

As for à la carte pricing, we believe it may have merit and deserves to be studied further. It could be a means to provide consumers greater control over what they purchase and definitely could permit parents greater control over what programming comes into their home.

If the Committee seeks to expand à la carte opportunities, we would recommend careful study perhaps of several different approaches. We also urge you though to require the cable industry to provide additional information unavailable to us and you now. For example, cable operators do not make known their channel programming costs, programming launch fee revenue, and corporate allocation of volume discounts. And it is evident that cable operators are not sharing their internal cost efficiencies with consumers.

The Committee should also consider its oversight and instruction to the FCC. There are numerous ways in which the FCC has not established or interpreted its rate regulation rules in a manner to protect subscribers. Congress should instruct the FCC to implement rules that protect the consumer from abuse and reflect the reality of today's non-competitive markets. We also need a more effective process for supporting local rate regulation.

In conclusion, local government has used its cable franchise authority to promote deployment of advanced services, and to the extent it can, has protected subscribers. We share your desire to increase wire line competition and reduce subscriber rates, and we stand ready to work with you on this important issue to our shared constituents. Thank you very much.

[The prepared statement of Ms. Praisner follows:]

PREPARED STATEMENT OF HON. MARILYN PRAISNER, CHAIR, TELECOMMUNITY AND
CHAIR, NATIONAL ASSOCIATION OF COUNTIES' TELECOMMUNICATIONS AND TECHNOLOGY
STEERING COMMITTEE

THE CASE FOR COMPETITION AND EFFECTIVE RATE REGULATION

Introduction

Good Morning Mr. Chairman, Senator Hollings and Members of the Committee. My name is Marilyn Praisner. I am a member of the County Council of Montgomery County, Maryland. I am testifying today as the Chair of TeleCommUnity and the Chair of the National Association of Counties' Telecommunications & Technology Committee. TeleCommUnity is an alliance of individual local governments and their associations, which seeks to refocus attention in Washington on the principles of federalism and comity for local governments' interests in telecommunications. NACo is the national association of the Nation's 3,066 counties and seeks to ensure county officials' voices are heard and understood in the White House and the halls of Congress.

I. Only Real Competition Results in Lower Rates

Mr. Chairman, in response to the GAO's cable rate report, you are quoted as stating:

"Consumers in the few markets with a choice of a second cable company pay 15 percent less for cable. The apparent implication for all other consumers is that they continue to be fleeced by their cable operators.¹"

We agree with your conclusion and thank you for the invitation to testify this morning.

In my testimony I seek to impart four thoughts:

- Local governments agree with you that only real competition creates downward pressure on rates –and real competition for cable exists only when a second wireline provider is present.
- Local rate regulation was thought to be a substitute rate restraint in the absence of competition, but FCC actions have frustrated rate regulation efforts by local franchising authorities. In addition, there are real limitations found in the Telecommunications Act which limits regulation to the basic programming tier. For example, were a local government to determine that an operator's basic rate was above that set by a competitive market, operators can limit choices on the regulated tier and move attractive programming to an unregulated tier. The result being that subscribers pay the higher rate selected by the operator.
- À la carte pricing could be a definite improvement over the current tier pricing system if it provides consumers direct control and choice over the channels they buy and the content that is coming into their homes while avoiding price manipulations by the cable operator.
- À la carte pricing is not, however, a solution to the real problem with cable—the lack of effective competition in the transmission platform. This monopoly transmission ownership gives the cable operator monopoly pricing power over the consumers and monopsony pricing power over the programmer.

II. Without Wireline Competition, Cable Rates Will Continue to Rise

Two studies, one conducted by the GAO at the request of this Committee, and a second study done by the FCC, have independently documented that cable rates are lower in areas where a competing cable service is available from a second wireline provider. The GAO study found cable rates to be 17 percent lower, and the FCC found rates were 8 percent lower. The challenge arises in that according to the FCC, only 2 percent of the 33,246 cable communities have overbuild cable competition, and it appears that the cable industry intends to keep it that way.

The GAO found that the seven largest cable operators serve 83.8 percent of all cable subscribers and the top seven do not compete against each other in any market. These numbers take on even greater meaning when the size of incumbent MSO and competitors are compared. The total subscriber counts of the three largest overbuild/competitive cable operators combined serve only slightly more than half the number of subscribers of Mediacom, the seventh largest MSO. The competitive cable operators together serve less than four percent of the number of subscribers

¹Frank Ahrens, *GAO Suggests Competition Good for Cable* Washington Post, October 25, 2003.

Comcast serves. Comcast is the Nation's largest cable operator with over 21 million subscribers.

The National Association of Telecommunications Officers and Advisors, the association that represents local cable regulators, testified before the Senate Judiciary Subcommittee on Antitrust, Competition and Business and Consumer Rights on February 11, 2004. In that testimony, NATOA ratified the findings of the FCC and GAO, described in detail various problems that have prevented the success of cable overbuilds, and pointed to specific legislative changes that might open the door to more overbuilders. However, experience with overbuilding makes local government believe that competition will continue to be scarce.

- *Direct Broadcast Satellite (DBS) Service Does Not Constrain Cable Rates.* While the cable industry has touted the threat posed by DBS, both the GAO and FCC in their research failed to conclude that DBS competition has a limiting effect on cable rates. The National Cable Television Association ("NCTA") claimed otherwise to the FCC, stating that cable's market power is restrained to the extent that there are competitive alternatives available to customers if a cable operator attempted to raise its prices. Local governments believe there are several factors that prevent DBS from being a true "competitive alternative" for major television market cable customers and thus from restraining cable prices:
 - *Non-Interchangeable Equipment.* It is easier for customers to switch between wireline competitors using cable modem and set-top boxes than it is for customers to switch between dish systems and cable boxes.
 - *No High-Speed Two-way Service.* DBS does not offer two-way high-speed data services comparable to DSL or cable modem. This means a DBS subscriber must still subscribe to a wireline service.
 - *Provision of Local PEG and Broadcast Channels.* In the GAO study, 47 percent of respondents cited the ability to receive local broadcast and cable channels from the same provider as a major reason for selecting cable, and DBS providers confirm that provision of local broadcast channels increases subscription rates. Yet local broadcast channels are offered by DirecTV or Echostar in only 62 of 210 television markets and local channels are offered by both providers in only 41 markets. In addition, DBS does not carry local Public, Educational and Government Access (PEG) programming.

III. Consolidated Cable Incumbents Are Using Aggressive Marketing to Eliminate Wireline Competitors

It is apparent that cable operators understand that other wireline providers provide the greatest competition. Competitive broadband providers, including nascent cable system overbuilders, have complained of incumbent cable operators using aggressive marketing tactics to drive these small competitors out of the market entirely—including deeply discounted introductory rates, *e.g.*, \$24.95 per month for 200 channels compared to \$77.90 per month in a neighboring community without wireline competition; cash bonuses, *e.g.*, \$200 to switch to the incumbent's cable service and another \$200 to switch to the incumbent's Internet service; and forgiveness of old debt owed by subscribers to the incumbent. It is also unclear whether the neighboring community's rates are being increased to offset the discounted price offered in the competitive neighborhood.

The NATOA testimony in February attached a detailed study of these practices which the Committee will find useful and informative. All of these factors together mean:

- Cable prices go down when there is wireline competition;
- Cable prices do not go down when there is no wireline competition or when there is competition only from non-wireline providers.

We believe any effective legislative attempt to reduce cable rates should focus in part on encouraging wireline competition. Any legislative reform of programming requirements should examine how cable operators may be using vertical integration and monopsony power to control competitors' access to programming to discourage competition. This issue should be addressed explicitly before considering cable operator requests for more control over programming.

IV. À La Carte Offerings Are An Improvement Over Current Tiers, but Alone Will Not Protect Consumers.

Cable rates will continue to rise significantly so long as cable incumbents exercise substantial monopoly and monopsony pricing power over cable consumers. Programming cost increases are not the primary culprit. The increases in cable rates since

1992 continue to run more than twice the rate of inflation. Programming costs explain only about 20–30 percent of this phenomenon.

In my jurisdiction, Montgomery County, Maryland, consumers have brought me a range of complaints about the dominant cable operator. We are seeing very high prices, with annual increases faster than the local rate of inflation. Cable rates have gone up each of the last three years by 3 to 4 times the rate of inflation. The “basic preferred” tier went up 9 percent and the “packages” went up 18 percent.

We are seeing the same price differentials attributable to cable overbuilds observed by GAO. For example, in the District of Columbia, where there is competition to Comcast, rates are \$5.50/month lower for expanded basic (\$3.00 lower for cable modem with cable TV and \$3.00 lower for cable modem without cable TV.) DC and Montgomery County are same metro area and prices and costs for programming and operations should be same. Cox TV (in Fairfax County) is \$3.00/month lower for expanded basic and \$6.00 lower for cable modem services with and without cable TV.

We are seeing cable services being moved between and among tiers with little or no explanation or warning. Consumers routinely complain that they are not offered the lowest available prices or accurate descriptions of their purchasing options when they call the company. The company is bundling cable modem and video services together in a manner that confuses any comparison pricing with DSL. The company appears to be forcing consumers to pay for digital converters and digital tier services when the consumer is seeking to buy pay-per-view and pay channels, despite the anti-buy-through language of the Federal law.

Most of the problem is caused by lack of effective competition. This allows cable operators to exercise their maximum pricing power to charge “whatever the market will bear” and to offer a quality of service only sufficient to maintain subscribership, not sufficient to make customers happy. Local government had hoped the 1992 Cable Act amendments would result in some pricing restraints. Other than the period of the FCC-imposed rate freeze in 1993–94, however, Federal rate regulation has not changed the price trend line. In part, this is because the 1992 amendments are unnecessarily complex and obtuse. In part, this is because the FCC over the last twelve years has not aggressively sought to restrain cable prices within the power Congress granted.

For this reason, NACo and TeleCommUnity would support a la carte offerings as part of a general repair to the existing cable rate regulation system. A la carte could be a means to provide consumers greater control over what they purchase. It might reduce some cable operator monopsony pricing power over programmers, similar to the must-carry/retransmission developments for over-the-air broadcasters. We also agree that a la carte offerings could permit parents greater control over what programming comes into their home. This does not necessarily mean lower prices for all consumers. A la carte offerings will not fully insulate consumers from aggressive pricing by cable operators holding substantial monopoly pricing power.

It is also important to carefully consider whether and how to mingle a la carte channels with the existing tier system of rate regulation. In the past, cable operators used their control over à la carte tier pricing as a means to charge more, not less, per channel.²

In 1994, the initial cable rate regulation rules exempted single-channel à la carte offerings. Operators began offering à la carte channels on a single and à la carte tier package basis. The single channel price, however, was so high that it only made sense to purchase à la carte channels as a tier package. However, because each channel in the à la carte tier was technically available as a single à la carte channel, cable operators claimed that the à la carte tier package was not subject to rate regulation (as other programming tiers were). On an ad hoc basis, the FCC permitted this à la carte tier arrangement so long as six or fewer channels were packaged together. Ultimately, the FCC found no sufficient justification for the tier restructuring “other than to avoid rate regulation.” Despite this finding, however, the FCC neither prohibited this evasion, nor sanctioned the operators for trying to avoid compliance with rate regulation rules.

We believe the FCC’s response provides an explicit warning to the Committee if it seeks to expand a la carte offerings without fundamentally reconsidering the existing rate regulation structure. The FCC’s ruling has provided an implicit incentive for cable operators to aggressively interpret the existing rate rules to their benefit.

²In its study, the GAO agrees with much of what NACo and TeleCommUnity feel about a la carte offerings. The GAO concluded: “If cable subscribers were allowed to choose networks on an a la carte basis, the economics of the cable network industry could be altered, and, if this were to occur, it is possible that cable rates could actually increase for some consumers.”

À La Carte Pricing Could Result in Channel Substitution, Not Lower Rates

Local government is not in a position today to recommend a particular form of a la carte roll-out. Our experience with cable rate regulation demonstrates the law of unintended consequences when the cable industry is able to game the system to its benefit. For now, we recommend the Committee study several different approaches. We remain committed to the goal that a package of basic PEG, broadcast and cable services should be available to all residents at a reasonable, fixed and predictable price. In addition, the rollout of digital technology offers the opportunity for true a la carte offering of all other services not part of a basic package. However, the problem is complex on a mixed analog/digital system. In this mixed world, operator-owned programming interests may affect decisions as to which channels will be offered as part of a non-basic package or as à la carte channels.

This is especially true with the growing convergence of cable companies and entertainment companies. Congress should be concerned about channel substitution which does not necessarily save the consumer money. For example, assume in New York City that Cablevision agrees to carry YES Network, drop ESPN from its expanded-tier programming, and make ESPN available as a separate à la carte channel. If there are no substantial savings in programming costs between YES and ESPN, or if programming cost savings are not passed onto subscribers, then the subscriber who did not want sports programming would see no price reduction, and the subscriber who wanted ESPN will have to pay the same price to receive ESPN-less programming or a larger price to receive the same programming with ESPN.

V. Cable Operators Have Not Presented Verifiable Programming Cost Data

Despite cable operators' claims that prices have risen as a result of programming cost increases, they have never provided local government with verifiable programming cost and revenue data to evaluate the impact of programming costs on cable rates. Notwithstanding the fact that a Justice Department investigation and an informal SEC inquiry related to the accuracy of operator-reported data are currently pending, Congress should require the cable industry to provide specific information about all channel programming costs, programming launch fee revenue, and corporate allocation of volume discounts.

- *Actual Programming Costs.* Cable operators submit only their basic tier channel programming costs to local governments as part of the rate regulation process and do not routinely submit any programming costs to the FCC. Thus, cable operators do not disclose to any regulatory body what they are paying for most of their programming.
- *Accounting Treatment of Launch Fee Revenue.* Cable operators receive substantial "launch fees" from programmers—i.e., fees for adding new channels to cable systems, for advertising new channels on existing channels, in program guides, on or with subscriber bills, and for other channel launch-related services—but do not uniformly treat them as programming revenues which offset total programming costs.
- *Allocation of Volume Discounts.* Cable operators often delay, or refuse to comply, with local government requests to disclose terms of their programming contracts, thus making it difficult to determine how volume discounts are allocated. In at least one instance, franchise-level reported programming costs were greater than the operator's actual costs because the operator negotiated volume discounts for programming, but charged its local franchises as if no discount had been obtained, booking the difference as profit for the corporate parent.

According to the 2001 Annual Report COMCAST filed with the SEC:

"[O]n behalf of the company, Comcast secured long-term programming contracts . . . Comcast charged each of the Company's subsidiaries for programming on a basis which generally approximated the amount each subsidiary would be charged if it purchased such programming from the supplier . . . and did not benefit from the purchasing power of Comcast's consolidated operations."

VI. The FCC Has Complicated the Regulation of Cable Rates

The Committee needs to consider its oversight and instructions to the FCC. In the view of local government, the FCC has not adopted cable rate regulations that ensure reasonable rates.³ There are numerous ways in which the FCC has failed to

³Local government has participated in all of the FCC's dockets reviewing and considering changes to its rate regulation rules. We are happy to share these detailed comments and critiques of the current rules with the Committee as you request.

establish or interpret rate regulation rules in a manner that ensures reasonable rates for subscribers. FCC inaction and delays make local rate regulation less effective, encourage operators to use the FCC appeals process as a means for running out the clock, and ultimately deny subscribers the protection from unreasonable rates that Congress intended. We need to establish a more effective process for supporting local rate regulation.

V. Conclusion

Local government has used its cable franchising authority to promote deployment of advanced services and has protected subscribers to the extent it has not been preempted by the FCC or Congress.

Increased wireline competition is needed to reduce subscriber rates.

Congress should:

- Require operators to disclose actual programming costs.
- Review the lessons to be learned from the 1994 à la carte tier pricing rules before implementing à la carte pricing in 2004.
- Instruct the FCC to implement rate regulation and à la carte rules in a manner that prohibits unreasonable rates, eliminates consumer abuses, and reflects the reality of today's non-competitive markets.

The CHAIRMAN. Thank you very much. Mr. Johnson, welcome.

STATEMENT OF RODGER JOHNSON, PRESIDENT AND CEO, KNOLOGY, INC. AND CHAIRMAN, BROADBAND SERVICE PROVIDERS ASSOCIATION

Mr. JOHNSON. Thank you, Mr. Chairman, and thank you for the opportunity to participate in this hearing and provide additional testimony regarding competition in the cable television market. I'm pleased to represent both Knology and the Broadband Service Providers Association, which is a trade association that includes the companies that the GAO has referred to as wire-based competitors in its most recent study sponsored by yourself and Senators DeWine and Kohl.

Consumers are reaping the benefits of a \$6 billion capital investment in new competitive networks. These new GAO reports again document that customers and communities served by broadband service providers, or BSPs, realize from 15 to 41 percent lower cable television rates than in communities where there is no wire-based competition. BSPs have shown that they not only provide consumers with demonstrable benefit for pricing and services, but they also are proving the economic strength of their business model. This is attested to by Knology's successful completion of its recent IPO, its initial public offering. This is the first IPO in the telecom or media sector in over 3 years.

These BSP systems are models for the type of competition envisioned by Congress in passing the Telecommunications Act in 1996. The key issue for policymakers today, however, is whether current legislation fully supports the continuing development of competition for video services. Knology and the BSPA are primarily concerned with three issues that if not addressed could slow the deployment of new competitive broadband networks.

First, regulators must not equate competition between cable and satellite with wire-based head-to-head competition. In our experience, despite the fact that satellite has 22 percent national market share, a fully upgraded cable provider often maintains a market share approach in 90 percent in local markets where it is only competing against satellite providers. We do not believe that 90 per-

cent or more of subscribers concentrated with one provider should be deemed fully competitive.

Senators DeWine and Kohl have sponsored a new GAO study to evaluate specific market structures as a follow-on to the work that's already been done and we ask for your added support. The goal of having this data by early in the fall and we would also request that this market analysis become a part of the FCC's next annual assessment competition at the end of this year.

The second key issue that we would like to talk about is the continued access to content necessary to compete, specifically the protections of the 1992 Cable Act were limited to satellite-delivered programs. This type of protection was both necessary and effective to support the development of the satellite segment of our industry. This was policy that truly encouraged the development of competition, and these principles of fair access to content need to be extended to all types of delivery technology, whether it's satellite or terrestrial in nature, and made a permanent foundation for the development of future desired competition.

Third, the BSP industry is threatened by other types of anti-competitive actions by incumbent operators, such as targeted predatory pricing campaigns or other conduct designed to prevent entrance from getting a foothold in a particular market. Predatory pricing strategies are frequently subsidized by significantly higher prices in surrounding markets that do not yet have the benefit of facilities-based competition. The FCC has recognized the public harm inherent in predatory pricing and has also disagreed that targeted discounts merely reflect healthy competition.

Finally, given that there was a lot of discussion earlier, I'd like to offer some comments regarding possible à la carte policies. As you evaluate any à la carte policy, we strongly suggest that consumer-focused à la carte policies should only be considered in conjunction with digitally delivered content. Implementing these structures on current analog channels would be both costly and problematic, as channels in the analog tier cannot be manipulated electronically.

There is significant momentum to migrate our systems and content to digital delivery and the application of any à la carte policies for consumer delivery of content should be considered in conjunction with that digital migration.

As a condition for carrying certain programming services that are demanded by a subset of our subscribers, we, as you are aware, are under today's program access structure required to bundle that programming with less desired programming on a tier available to all subscribers. The end result is that consumers frequently pay for high cost content or other content that they truly don't want. An alternative à la carte policy could require that distributors or providers be given à la carte access to individual channels from content providers without any kind of artificial placement requirements, thus allowing the providers to compete by offering their own unique content bundles.

Go back to the either/or scenario that you alluded to earlier. This could produce lower prices to consumers without immediately requiring a pure à la carte offering across the board. Driven by freer competition, it's likely that you'll see more focused packages for

content from sports, family, movies, education, or a variety of other target content categories. Today's structure creates bundles heavily influenced by content producers, resulting in forced carriage and forced placement of high-cost or low-demand content.

In closing, the BSPA and the broadband service providers have shown that in markets that they serve, consumers enjoy the benefits of lower prices for broadband services. In order to continue to expand the availability of competitive broadband services, policy makers need to recognize that the market for cable television is not yet fully competitive and take care to prevent incumbents from erecting any artificial barriers. Moreover, access to content is a threshold issue that needs to be addressed.

I want to thank you again for this opportunity and look forward to your questions.

[The prepared statement of Mr. Johnson follows:]

PREPARED STATEMENT OF RODGER JOHNSON, PRESIDENT AND CEO, KNOLOGY, INC.
AND CHAIRMAN, BROADBAND SERVICE PROVIDERS ASSOCIATION

Good morning. I want to express my appreciation to Senators McCain and Hollings for this opportunity to participate in this hearing and provide additional testimony regarding competition in the cable television market. I am pleased to represent both Knology and the Broadband Service Providers Association (BSPA), a trade association that represents companies the GAO referred to as wire-based competitors in its most recent studies sponsored by Senators McCain, DeWine and Kohl.

Consumers are reaping the benefits of a \$6 billion capital investment in new competitive networks. These new GAO Reports again document that customers in communities served by Broadband Service Providers, or BSPs, realize from 15 percent to 41 percent lower cable television rates than consumers in communities where there are no wire-based competitors.

BSPs have shown that they not only provide consumers with demonstrable benefit on pricing and services, but they are proving the economic strength of their business model. This is attested to by Knology's successful completion of its Initial Public Offering. This is the first IPO in the telecom/media sector in over three years.

These BSP systems are models for the type of competition envisioned by Congress in passing the Telecommunications Act of 1996. The key issue for policy makers today, however, is whether current legislation fully supports the continuing development of competition for video services. Knology and the BSPA are primarily concerned with three issues that, if not addressed, could slow the deployment of new competitive broadband networks.

First, regulators must not equate competition between cable and satellite with wire-based head-to-head competition. In our experience, despite the fact that satellite has a 22 percent national share, a fully upgraded cable provider often maintains a market share of 90 percent or greater in local markets when it is only competing against satellite providers. We do not believe that a market with 90 percent or more of subscribers concentrated with one provider should be deemed fully competitive.

Senator's DeWine and Kohl have sponsored a new GAO study to evaluate specific market structures. We ask for your added support for this study with the goal of having data by early fall. We further request that this market analysis become part of the FCC's next annual assessment of competition at the end of this year.

The second key issue is ensuring continued access to the content necessary to compete. Specifically, the protections of the 1992 Cable Act were limited to satellite-delivered programming. This type of protection was both necessary and effective to support the development of the Satellite segment of our industry. This was policy that truly encouraged the development of competition. These principles of fair access to content need to be extended to all types of delivery technology, whether it is satellite or terrestrial, and made a permanent foundation for the development of future desired competition.

Third, the BSP industry is threatened by other types of anti-competitive actions by incumbent operators, such as targeted predatory pricing campaigns and other conduct designed to prevent entrants from getting a foothold in a particular market. Predatory pricing strategies are frequently subsidized by significantly higher prices in surrounding markets that do not yet have the benefit of facilities-based competi-

tion. The FCC has recognized the public harm inherent in predatory pricing and also disagreed that targeted discounts merely reflect healthy competition.

We would also like to offer some comments regarding possible a la carte policies. There has been recent discussion about the potential for an a la carte policy to help contain rising cable rates on the bundles of channels that consumers are forced to buy in today's structure. As you evaluate any a la carte policy, we strongly suggest that consumer focused a la carte policies should only be considered in conjunction with digitally delivered content. Implementing these structures on current analog channels would be both costly and problematic as channels in the analog tier cannot be readily manipulated electronically. There is significant momentum to migrate our systems and content to digital delivery and the application of any a la carte policies for consumer delivery of content should be considered only in conjunction with migration to digital.

Today's program access structure gives significant power to both vertically integrated and independent content producers. As a condition to carrying certain programming services that are demanded by a subset of our subscribers, we are required to bundle that programming with less desired programming on a tier available to all subscribers. The end result is that consumers frequently pay for high cost content or other content they really don't want and some industry segments, like Sports, have artificially inflated their revenues. An alternative a la carte policy could require that distributors be given a la carte access to individual channels from content providers without artificial placement requirements. This would allow distributors to compete by offering unique content bundles to meet consumers' real desires. This could produce lower prices to consumers without requiring a pure a la carte offering to consumers that cannot be technically supported for many years. Driven by freer competition, it is likely that you would see more focused packages of content for sports, family, movies, education or a variety of other target content categories. Full and free competition can help determine the level of a la carte offering desired by consumers. Today's structure creates bundles heavily influenced by the content producers resulting in both forced carriage and forced placement of high cost or low demand content.

In closing, Broadband Service Providers have shown that in markets they serve, consumers enjoy the benefits of lower prices for broadband services. In order to continue to expand the availability of competitive broadband services, policymakers need to recognize that the market for cable television is not fully competitive and take care to prevent incumbents from erecting artificial entry barriers. Moreover, access to content is a threshold issue that needs to be addressed as part of the new Telecom Legislation expected in 2005. I want to again thank you for this opportunity to be here and look forward to your questions.

The CHAIRMAN. Thank you very much, Mr. Johnson. Mr. Robbins, I'd like to congratulate the cable industry on its recent decision to allow customers who are offended by the content on particular cable channels to block such channels at no additional cost. However, a number of parents groups sent me a letter making this point. Why should parents have to subsidize cable channels that undermine their core values and beliefs? Why should a parent who wants their child to benefit from educational programs on the Disney Channel or the Discovery Network also have to pay for offensive material?

In other words, they're paying you because they are required to because it is a package only, and then you're allowing them to block it and they're still paying for what you're blocking. Help me out here, Mr. Robbins.

Mr. ROBBINS. Well, I—Mr. Chairman, I certainly understand the dilemma there, but I think that just begins to go at the whole a la carte issue, which is essentially saying, pick and choose what you want, and that frankly is long-term where this industry is going to go with video on demand. But there's something like a \$30 billion or \$40 billion bridge to get over to make that technology available to every television set in America.

So as consumers demand that more, and that is happening, that will be the world of the future, but there's a huge investment that has to go in beforehand. I honestly think the marketplace is driving us in that direction, and I think the notion of government getting involved in refunding onesies and twosies is a disastrous scenario for government and for the American consumer, to say nothing of the industry.

The CHAIRMAN. Well, as I said before, when I go buy a newspaper, I don't have to buy Sports Illustrated, Popular Mechanics, and a number of other periodicals along with it. That's a much more valid comparison than buying parts of a newspaper. But—go ahead. Mr. Robbins, I mean, we just have a fundamental disagreement here.

Mr. Bodenheimer, I don't know of any ESPN in America that's available à la carte, do you?

Mr. BODENHEIMER. I'm sorry, any ESPN?

The CHAIRMAN. Programming that's available à la carte, do you?

Mr. BODENHEIMER. Well, it depends how you look at it. We have—

The CHAIRMAN. That's not part of a package where they receive other channels. That's what I mean by à la carte.

Mr. BODENHEIMER. You can buy ESPN—are you talking about the distributor, the cable operator, or the consumer?

The CHAIRMAN. I'm talking about the consumer. I don't know of any consumers in America that can say I just want ESPN alone.

Mr. BODENHEIMER. There are ESPN products that are available by itself, ESPN High Definition, for example, is available in and of, by itself once you have bought through up into a tier. That's how many cable operators are offering it now.

The CHAIRMAN. But you bought in through a tier. I'm talking about just—look, here's my point. In Canada, I've got four different cable companies, this is a little bit like the drug reimportation program, you've got four different cable companies you can subscribe to where ESPN is à la carte, but yet subscribers in the United States of America don't have that same ability.

Mr. BODENHEIMER. I think, and have said numerous times in the last year or two as this conversation has come to light, that an expanded basic package in America is perhaps the greatest entertainment value that's ever been created. If you look at where this industry has come in the last 25 years, there are 90 million Americans that seem to agree with me and agree with that premise.

So my point of view is, what we have assembled with the cable operator and now the satellite operators are a tremendously popular service.

The CHAIRMAN. I understand your opinion and your great success, but I find it interesting that in Canada they can purchase ESPN on an à la carte basis, and I know of no place in the United States where you can.

Mr. Kimmelman, do you want to comment real quick because I've got a couple other questions?

Mr. KIMMELMAN. Just real fast, Mr. Chairman. They should be able to have that basic package and they should be able to get 90 million people, but why shouldn't some of those 90 million be able to buy it separately, number one. And number two to Mr. Robbins,

we appreciate the effort of the cable industry to help consumers block, but please help me out here. I've gone to your website, I've gone to the website of half-a-dozen cable companies. I can't figure out how to block anything but a digital channel. You mentioned blocking off of analog. I mean, I've got people who are technical experts trying to figure out how to navigate your website and all I see is digital promotion, digital promotion, but it's virtually—talk about Soviet style presentation. The blocking is a wonderful concept, but how do you get it?

The CHAIRMAN. Mr. Robbins, you can respond to that, but I also would like for you to respond, the issue I'm—last May you appeared before this committee, and I quote you, the issue that I'm here to speak to is a combination of high priced and broadly mandated distribution in program offerings. That's what has happened in the sports world. My issue is, let's go to a tier, let us let the consumer choose whether they want to pay for that high priced service or not. It's no more complicated than that. I'm suggesting that when services like ESPN get over a dollar a wholesale level per month, that the consumer be given the opportunity to choose whether or not they want that and price it accordingly.

In your written testimony today after you have made an agreement with ESPN, in your written testimony today you state that à la carte pricing, quote, does not work and is not in consumers' best interest, as it results in higher prices and fewer program choices. When did you find yourself on the road to Damascus?

Mr. ROBBINS. As soon as Mr. Bodenheimer got real in his pricing for futures and we got there—

The CHAIRMAN. But I thought you were articulating a principle there last May, not a situation.

Mr. ROBBINS. I'm on the same page as you, Mr. Chairman, that I want the lowest possible rates I can possibly afford to give to my customers. My efforts last spring to move ESPN, the highest priced service we have, to a tier was to get the attention of the Walt Disney Company and to bring them to reasonable levels of prices.

We were in the marketplace successful in doing that. It's not totally fixed. You've heard many comments here about the sports business model being broken. I still think it is broken. We made a huge step forward without disrupting an entire industry in our agreement with Mr. Bodenheimer.

The CHAIRMAN. Well, I apologize to the Members of the Committee. This is the Commerce Committee, not the Sports Committee, but we seem to be spending a lot of time on sports. But I do think that the reason why we're doing that is the largest single cause of increase in subscriber costs is the cost of the programming, and that's why we are focusing a lot of attention on that.

My time is expired, but please respond, Mr. Robbins.

Mr. ROBBINS. Well, my—

The CHAIRMAN. Go ahead, please.

Mr. ROBBINS. More than often than I'd like to, but that is exactly why we went to the amount of trouble that we did to try to reign in the largest segment of our cost, which was the sports programming cost. We have made a major step forward in realigning the balance, if you will, between sports programming providers and distributors. So that's what we were working on, that's why the

noise last year, and that's why I'm happy to tell you that we've got a settlement that's moving in the right direction.

The CHAIRMAN. Last year you said, I'd like to make sure the record shows that it's been mentioned here earlier that we are in the sports programming business. We're indeed in Louisiana. We offer that on a tier to give our customers the choice. Apparently that's not the case anymore.

Mr. ROBBINS. No, that is the case. You can buy it on basic, you can buy it on a tier, whatever way you want. The price varies. Obviously if you go to a tier which doesn't have—has broad distribution, the price is considerably higher than if you have it on basic.

The CHAIRMAN. Well, I'll send you the information we got off your website. Senator Breaux. I'm sorry, Senator Wyden.

Senator WYDEN. Thank you, Mr. Chairman. I want to stay at this sports issue, Mr. Bodenheimer, because 2 hours ago I started this hearing by saying I didn't think there were any incentives to hold sports costs down. The General Accounting Office, in response to my questions, said that the area where it was most likely to make sense to have a tiered model was in the sports area, and I want to walk you through a couple of these issues.

Let me stipulate, I got to go to college on a basketball scholarship, so I live for sports. I think people are going to choose it under any of these kinds of scenarios. And you said that competition discipline prices, I think we all agree with that, and certainly for the most part high prices scare away consumers so that producers have incentives to keep the price down.

But even given what we have just seen in discussion with you all and Mr. Robbins with Chairman McCain, consumers don't get to decide in this area whether the price is too high. In fact, they're not even going to know what the price of ESPN is because it's all bundled into one broad kind of package.

So my question is, given that consumers don't get to see the price, don't even get to decide for themselves whether that price makes sense for them, take us specifically through the incentives that now exist for ESPN to hold down costs?

Mr. BODENHEIMER. Well, with all due respect to the GAO, it couldn't be any more simple. Like any businessman, I'm incented to keep my expenses low when I have a limit on what kind of revenues that I can bring in. ESPN has two principal revenue streams. We have the revenue we get from our distributors, the cable and the satellite operators, and as you just heard Mr. Robbins say, we came to an agreement whereby he was satisfied we had reached an appropriate value for ESPN, but I have capped that now for 9 years.

On the advertising side, I couldn't be in a more competitive world. There's about \$12 billion of advertising up for grabs every year in the national cable advertising business and I have a sales force that fights tooth and nail for every unit we can buy—excuse me, sell. So I can't just dictate how much ad revenue we're going to bring in.

So on my two major revenue streams, I'm capped on my affiliate side and I'm in a dog fight with 100 other cable networks and broadcast networks for ad revenues, so that's my incentive to keep my costs low.

Senator WYDEN. I think it's fine to say you and some other powerful interests should negotiate and try to bargain, but what you're excluding is the big bargaining force out there, which is the consumer and the consumer knowing what prices are. And I think you still have locked those people out of what is just economics 101, markets driven by consumers.

So given the fact that you have some bargaining power, given advertisers and the like, what gives the consumer any bargaining power knowing that, in effect, they can't even find out what the price is for your service because of the bundling of the package?

Mr. BODENHEIMER. Well, two things there. Number one, as the industry has progressed, more and more people are reporting what wholesale costs are paid by cable operators and satellite in the newspaper. In fact, I saw today in the *USA Today* over my morning coffee what our wholesale figures, so it's certainly not in a shroud of secrecy.

Senator WYDEN. You're saying consumers are able now to figure out wholesale prices in this area?

Mr. BODENHEIMER. It's in the *USA Today* today and the point that DirecTV is making that they don't wish to pay any further programming increases. They printed a bar chart.

Senator WYDEN. If you had à la carte pricing in the sports area, the area where GAO said it was most likely, wouldn't you have a situation where sports channels would worry that if they had to pay NBA or NFL these huge sums, that that could serve as a price restraint because you'd have to worry about the sky-high contracts and you could end up having sports programming to drop?

Mr. BODENHEIMER. I'm sorry. I don't follow your question.

Senator WYDEN. See, if you had à la carte pricing, sports channels would have to worry that if they paid the NBA and the NFL a gazillion dollars for a particular contract, they might end up losing subscribers, because that would ripple all the way through the system. What is wrong with that argument?

Mr. BODENHEIMER. I have to worry about that every day under the existing environment. I've got to negotiate contracts with cable and satellite operators. These contracts are continuously evolving as you've seen right here in this committee. There are disputes over what the fair value of that is. I've got to deal with the advertisers, I got to keep my ratings up. I'm in that fight every day, Senator.

Senator WYDEN. I don't think you have to worry about it at all. You cook your deal with the advertisers and some of these other powerful interests and the consumer pays whatever it's going to be because we know consumers love sports. And what Senator McCain and I are trying to do is get you to tell us about how you're going to let the consumer use the marketplace in line with the free enterprise system, and you have locked them out. Consumers want sports, I certainly want sports, and now you've got a situation where we're going to tell you you can get sports as long as you pay for all of these ballooning costs. We think that's wrong.

Mr. BODENHEIMER. May I just—

Senator WYDEN. If I might, I only have another minute. Mr. Chairman, I want to let Mr. Bodenheimer have another comment if I could ask one last question.

Mr. BODENHEIMER. Thank you very much. I just want to add one point. There is an awful lot of sports programming on broadcast television. I happen to run one of those divisions. Those broadcast stations are carried in the broadcast basic, and 10 percent of Americans, of television homes, 10 million people today already make the election that you just said doesn't exist. They say, I've got enough sports on my broadcast basic for \$12 and I'm happy with that.

That often gets overlooked here. Ten percent of Americans don't select the big broad cable package that ESPN has offered.

Senator WYDEN. And 90 percent of the consumers by your calculus have no marketplace power. They don't even know what the price is. That's what's wrong and hopefully we'll change it.

Mr. Kimmelman, if I can get just one question for you. With respect to cable consolidation, if a small handful of cable companies continue to have this level of marketplace domination, isn't that going to continue to affect programming choices and also prices?

Mr. KIMMELMAN. Absolutely, and I would just broaden it, Senator Wyden. It's a small handful of media companies, because in this instance it is cable companies who own programming, like Time Warner, it is ESPN owned by Disney, which also owns ABC, which may be bought by Comcast, a major cable company. It is DirecTV, one of those two satellite companies out there who are supposed to be competing against cable now owned by Newscorp, the owner of the Fox network, Fox regional sports channels, FX, and on. It is a handful of companies who all make their money from programming and only three distribution channels to the public in most communities, one cable, two satellite. If they can control the price of the programming going out on both, they control prices and they control what you get to see, and I see an ever-escalating spiral as these few companies gain more power.

Senator WYDEN. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Robbins, I'll send you off your Website, it has Cox sports television on the expanded basic. That's from your Website. Senator Smith.

Senator SMITH. To follow up on my colleague from Oregon's questioning, what percentage of sports is watched on networks and what percent is watched on cable? And I'm also hearing here that most of the cable is owned by the networks. Is that right?

Mr. BODENHEIMER. I'll try the first part of your question. I don't have this down in my head, Senator, but I'll estimate that cable sports is 30, 35, 40 percent of sports viewing in the country measured by ratings.

Senator SMITH. Sixty-five percent being on networks?

Mr. BODENHEIMER. Correct.

Senator SMITH. And isn't a fact that most of what goes—are all the cable companies owned by networks or are there some that—OK, I didn't think so, but I think I've heard there are a few. ABC owns a cable company. Wouldn't most of the increases to athletes from TV revenue go then through the networks and not the cable, or is it all just factored in?

Mr. BODENHEIMER. We as a TV network, whether we had our broadcast hat on or cable and we have no control over what the athletes are paid by the team owners.

Senator SMITH. Do you feel pressure from them, from the leagues to—that they’re passing those on to you though? Do you ever push back? That’s what I’m asking.

Mr. BODENHEIMER. No, I push back a regular part of my day.

Senator SMITH. OK. I want that to come out because I hope everybody understands there are market forces here that may not be perceptible by us on this dais.

Mr. BODENHEIMER. Well, on that note—excuse me for interrupting, I didn’t allow you to finish.

Senator SMITH. No, I want people to understand as best we can to understand all of the market forces that are in play that we may not perceive through just a quick look at your industry.

Mr. BODENHEIMER. You’re seeing input costs and other expenditures moderate on a variety of levels. One example is the rate of increase that we have been seeking, which Mr. Robbins spoke about and that we’re doing with other cable operators. The rights fees that sports leagues are getting, not necessarily what they’re asking for but what they’re settling for is moderating in some cases. Whether that plays out to the top echelon of sports leagues remains to be seen, but it is moderating. And even retail cable pricing this year has moderated itself on a retail basis.

So I think you’re seeing some flattening of the marketplace that you were asking about.

Senator SMITH. Mr. Robbins, one thing I have heard that is of concern to me about bundling, and I’m obviously revealing to you my bias against our getting involved in telling you how to market your product, but I think you lose the moral high ground if you’re bundling pornographic channels with Nickelodeon and family offerings, and I would plead with you to post haste stop anything like that.

Mr. ROBBINS. Senator, I don’t think we’ve ever been there. I think what was referred to—

Senator SMITH. But the implication is here in this hearing that that’s happening. Are you telling me that’s not happening?

Mr. ROBBINS. Let me be very clear. There was a reference here by one of your distinguished colleagues about the Playboy Channel with—I have it written down actually because I wanted to mention it—but the Playboy Channel has always been a pay channel, separately encrypted, locked out, never been on any kind of expanded basic tier of service.

Senator SMITH. I don’t know it because I don’t take it, but the implication is here that’s happening. Are there quasi-pornographic channels that you bundle that are not pay?

Mr. ROBBINS. No, sir.

Senator SMITH. Now how about the letter that Senator McCain read though, the people are writing to the Chairman that they’re subsidizing these other things. Are you refuting that? Are you refuting the premise of the letter to Senator McCain that you’re not bundling things that your customers are subsidizing? They want Nickelodeon and they’re having to pay for some quasi-pornographic material?

Mr. ROBBINS. No, there is no mixture in the analog universe with pornographic channels, or again, the specific reference to the Playboy Channel. That is a pay service—

The CHAIRMAN. We're talking about things like MTV, Mr. Robbins, that parents may find offensive. I may not.

Senator SMITH. And that's why I talked about it as quasi-pornographic, because I do think if you can segregate, you will strengthen your position if you can segregate these kinds of offerings. If they are currently being bundled, I would try to regain the moral high ground to make sure they're not. I say that as someone who is not unfriendly to your industry. I want to see you succeed and I do believe, I want to say for the record, I do believe that many of the concerns being expressed by my colleagues will soon be remedied by a very vigorous marketplace that is emerging. If you're making a lot of money, you're soon going to have a lot of company. If your industry is making a lot of money, you're going to attract competition.

Mr. ROBBINS. Senator, with all due respect, I think we have. The telephone companies are coming at us with a vengeance. The satellite companies are coming at us with a vengeance. Every day in our business is election day. People can turn off their cable and go to satellite. They can turn off and go to broadcast. They don't need us to live. Our future rests on how well we are serving our customer.

Let me just come back to the indecency point though. You talked about Playboy and other channels. Some people may find MTV indecent. I don't watch MTV particularly, but therein lies I think a very tough call about First Amendment, and I don't want to introduce all of that here, but we in the industry I think are extremely sensitive to what's going on, not only in the country but here in Washington, and are doing everything we can to give our customers choices such as the blocking capabilities that have been reported earlier this week.

We appreciate your sensitivity. I like where you're coming from with respect to this industry. We need to fix our own problems. We don't need your help to do so.

Senator SMITH. I appreciate if you would be sensitive to that and if you can, segregate Nickelodeon and MTV, I think that that gives you a strong position, and so whatever technologies you have there I would recommend them and I, again, would reiterate for the record, I think that competition is coming, and you know that and there—hopefully if we hold this hearing next year that will be reflected in the kind of results in consumer choices that are available that we can ascertain. Thank you.

The CHAIRMAN. Mr. Robbins, I'm not setting my standards. I'm talking about standards that parents have about programs that they might find offensive or unacceptable for their children to watch. This letter, which I'll give you a copy of, from the Parents Television Council, has some very graphic examples which I will not read now, which I'll give to you, which are on MTV and Comedy Central's South Park and others that are part of your basic package.

So we return to the fundamental question, should people pay for channels that they don't want that they are going to be able to block thanks to your—or hopefully will be able to figure it out—should they pay for channels that they don't want their children to view? That's the problem with a basic package.

Senator Cantwell.

Senator CANTWELL. Thank you, Mr. Chairman. Mr. Johnson, I think you were pretty clear in your testimony in how you look at bringing competition to this marketplace. The first thing you said was that there needed to be fair access to content from all technology delivery. So are you recommending that we go back in and change the Satellite Act to be specific about other types of technology?

Mr. JOHNSON. No, no, no. I think the Satellite Act has accomplished what it was intended to accomplish when it was put into effect. I do think it has broadened the competitive base that we see in place in the marketplace. I think what we do need to look at, and since we've been on a sports junket here, some of the terrestrial-delivered news and sports programming is often precluded from the little guys in the marketplace. And what it does, it creates a competitive disadvantage for us and——

Senator CANTWELL. So are you talking about compulsory licensing from content providers? How would you achieve the goal of having it technology neutral?

Mr. JOHNSON. What we would argue is the same availability be provided to competitive providers of content that is terrestrially delivered as it provided for content that is delivered by satellite.

Senator CANTWELL. So but we'd have to change that. We could come with a new——

Mr. JOHNSON. Yes, yes.

Senator CANTWELL. You're just saying——

Mr. JOHNSON. The act, the act does not address terrestrial, OK?

Senator CANTWELL. So come up with a new act. Mr. Kimmelman, do you support that?

Mr. KIMMELMAN. Yes, I think that's a step one. You need to do a lot more in terms of preventing discrimination between who owns the programming and distribution systems and others who seek to come in and compete.

Senator CANTWELL. So the other panelists support that legislation?

Ms. PRAISNER. I think it needs to be looked at. I don't think that we can in local government, but we do know the challenge that overbuilders are having from a variety of places that have been indicated to us, so I think that needs to be explored.

Senator CANTWELL. Mr. Robbins, can you stand that competition?

Mr. ROBBINS. Senator, we have competition in a number of our markets and——

Senator CANTWELL. So Cox would support that legislation?

Mr. ROBBINS. I'm sorry?

Senator CANTWELL. So Cox would support that kind of legislation?

Mr. ROBBINS. I'm not suggesting we would support that legislation. I'm suggesting that the marketplace is wide open. We have no exclusive franchises. Anybody can come in and I win every day because I provide better service and a better value for my customers than the next guy.

Senator CANTWELL. But if Mr. Johnson can't get access to that content, then how can he offer a better program? His point is that there should be more competition between distributors, and if ev-

everybody has access to the content, then distributors could offer different bundling options, and thereby see what consumer demand really is for those bundling options.

Mr. ROBBINS. I hear you. I'm not sure that the overbuilders that are in our marketplaces have any problem getting any of the programming that we have.

Senator CANTWELL. Mr. Johnson?

Mr. JOHNSON. We're not in any of Mr. Robbins' markets, so I can't speak to what Cox's policies are, but in certain markets, yes, we have, and a number of the other overbuilders that I speak for on behalf of the BSPA have challenges getting content. Mr. Robbins said that there are—they don't have any exclusive franchise agreements. We agree with that. There is no franchise exclusivity. We can go into any market. But Senator Cantwell, you're on the right tack, and that is content availability, not franchise availability.

Senator CANTWELL. Well, I think to this degree. I mean, I don't think we really know. I think in the online world right now we're finding out exactly what consumers do want and I think artists are probably adjusting. Artists had to come up with 13 or 14 other songs to put on a CD. I'm not sure they absolutely wanted to do that. So we're finding out what consumers really will buy on a pay-per-song or pay-per-view paid demand system, so I think there's a lot to learn.

But certainly this seems like the most logical step to take right now to create competition, but it would be a compulsory license system. You also mentioned in your testimony that you thought that access to content ought to be considered in any kind of telecom legislation looking forward. Were you talking about just increasing the competition with other providers besides the—

Mr. JOHNSON. I think what we're talking about is content ought to be available to, you know, let's just say the large telephone companies want to get into the video business and they decide to do it not on a satellite partnership basis. If they want to, they ought to have access to content too. It ought to be content availability for everybody, or else we'll end up in a situation like Mr. Kimmelman suggested, that a small group of people control what we all see and from whom we all see it or hear it.

Senator CANTWELL. Mr. Robbins, did you have—

Mr. ROBBINS. Well, U.S. West is in competition with us in Omaha, Nebraska and they have all the services that we have.

Senator CANTWELL. But right now I think content providers are a little more in the driver's seat than people realize. They might be out in the audience but they're not really represented up here today. And that's the question is who's got the choke hold on the consumer. I think the Chairman is asking a very appropriate question about à la carte content, but I'm somewhat empathetic to the fact that these business models have to change and they have to change over time and that if you do it in a quick reaction, yes, it causes great havoc to an industry.

But when switching from an analog to a digital world, we have a whole different ball game here, and the thing that we're ignoring is that IP, Internet protocol, delivery of content, dramatically changes the field. Why not have open competition to that and make

content available to everybody? Let's see what people come up with as far as bundling and content. I'm seeing lots of yeses but——

Mr. ROBBINS. I think that's the world we're going to. I said that earlier that I think we are going to that digital world over time. There's a \$30 billion bridge to cross to get there, but I think we're going there, Senator.

Senator CANTWELL. So I'm heartened to think that you might believe, Mr. Robbins, that then open competition by everybody to that marketplace with some sort of content availability, either compulsory license or what have you is the way to go.

Mr. ROBBINS. Well, I'm not sure of all of the implications of what you're saying there, but we're in the marketplace with all of my content providers every day struggling to figure out what our consumers want, trying to be responsive to their needs for convenience, for entertainment, so forth and so on.

Senator CANTWELL. I see my time is expired, but I think what I'm talking about, Mr. Robbins, is competition.

Mr. ROBBINS. And I'm saying we're there.

The CHAIRMAN. I think Mr. Johnson would like to——

Mr. JOHNSON. One comment too. Earlier I think Mr. Bodenheimer said that it was wrong to say programming costs are the reason for rate increases. One of the things we did when we had to go through—for the last 2 years we've evaluated our rate increases in our markets and we looked at, and we actually published a document that said, here's what the percent programming cost increases were and here's what our rate increases were so we could share it with our consumers. We didn't name any channels or any programmers or what have you.

But in every instance, our programming rate increases were significantly higher than what our consumer rate increases are. That is, that content area, that competition area is what's driving.

Senator CANTWELL. Thank you, Mr. Chairman.

The CHAIRMAN. Did you want Mr. Kimmelman to comment?

Senator CANTWELL. Yes, if he has further comment.

Mr. KIMMELMAN. Senator Cantwell, I think you're absolutely right about the transition to digital. It changes the entire ball game and I think as we have called for unbundling the services for consumers, I think Mr. Robbins makes a good point. Cable operators shouldn't be stuck in the middle either. They should be allowed to either buy ABC and ESPN and the whole package that Disney wants to sell or also buy individual channels from them. And maybe if you would split it up on both sides, both wholesale and retail, you would get the open market with a consumer-driven demand model that we're looking for.

Senator CANTWELL. Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman. As a general rule, I'm not a big fan of government intervention and regulation in prices, but with all of the discussion about the impact of the channel pricing and cable pricing on the cost, high cost of major league sports, I can't help but wonder if perhaps government price regulation for cable would have resulted in A-Rod playing shortstop for the Red Sox.

[Laughter.]

Senator SUNUNU. With regard to content, Mr. Robbins, Cox has at least partial ownership in a number of channels, correct?

Mr. ROBBINS. We have an interest in Discovery Communications, we have an interest in a regional sports network in Louisiana.

Senator SUNUNU. Content, channels content, right?

Mr. ROBBINS. Pretty small.

Senator SUNUNU. But you're the best we have. We've got five people here, and in terms of having ownership of distribution and some ownership of the channels, my question is whether or not there's any limitation or discrimination on the availability of those channels or that content on your network versus overbuilders or any other networks with whom you compete?

Mr. ROBBINS. No, in our Louisiana sports network, which is really built around the Hornets, that is available to other distributors in Louisiana. Again, they can get it on a tier where they pay more because there's obviously much less circulation, or they can get it as we provide it as part of our expanded basic service.

Senator SUNUNU. Mr. Johnson, is that your experience that at least insofar as distributors? We talked about retransmission consent, but setting that aside for a moment, with regard to other competitors that own distribution, are you able to get the channels or the content that they might also have an interest in?

Mr. JOHNSON. There are numbers of examples, and I'm speaking on behalf of our association right now as opposed to my company. We haven't run into that kind of a scenario in my company because we tend to be in secondary and tertiary markets as opposed to primary markets. But there are examples that the BSPA has and we'll be happy to provide those to this committee of examples where content has been denied by—

Senator SUNUNU. If you could provide those I'd appreciate it, because I think the general concern that if someone is selling content into the market that they do so in a consistent way and a fair way is an important one.

Mr. ROBBINS. And it generally goes back to the terrestrial question we were discussing earlier.

Senator SUNUNU. Mr. Robbins, Chairman McCain talked about a situation or a concern where, with the upgrades and the new technology and the digital boxes being built out that has costs and the costs are reflected in, at least to a certain extent, the price of cable, but the concern might be that those who still have a basic analog package would be left holding the bag or be left having to absorb costs from which they do not benefit. How do you respond to that?

Mr. ROBBINS. Senator, I thank you for asking that question because it's a critically important—

Senator SUNUNU. Actually I was trying to help the Chairman here and drive home his point a little bit more, but please.

Mr. ROBBINS. Well, anyway I can help the Chairman I want to do that too, but in fact we saw video competition coming as early as 1988 and decided at that point in time that we had to build out our networks for more robust capability, and it turned out that that has served us very well being able to provide Internet service, being able to provide telephone service. I think we're the leading provider of telephone over cable, whether it be circuit-switched or voice over IP.

If, in fact, we had not done that, I submit to you the increases that we have passed on to our customers in the video side would have been higher. It is in fact the investments that we've made in greater capability that has allowed us to bring our video increases down below industry averages over the last few years.

Senator SUNUNU. Mr. Johnson, you provide primarily in a digital format from the get-go?

Mr. JOHNSON. Yes, we do.

Senator SUNUNU. Do you have any—

Mr. JOHNSON. We have a similar experience as Mr. Robbins as his firm. We have fully upgraded facilities in all of our markets, and we provide, as he does, all three services, video, voice, and data services. And I think that fact that we've been able to provide all three services has allowed us, when you're getting three revenue streams off of a single pipe into a home, to leverage that investment. It was a wise decision to upgrade the network.

Senator SUNUNU. Mr. Kimmelman, you've been here a number of times before and you make among the more passionate arguments for some kind of price regulation in this area. But I'm curious to know, I think I mentioned it earlier, whether or not you're aware of a similar industry product where there is government requirement that a product be sold in an à la carte way that we can look to for some guidance as to what the impacts would be? You obviously think they'll be good. Some people have raised concerns. But where can we look for a comparison?

Mr. KIMMELMAN. I would start with our own law, the 1992 Cable Act. There is a government imprimatur very interestingly described as a re-regulation law, where government said, cable companies, you are fully deregulated other than your basic tier if you offer channels à la carte. Otherwise, you're price regulated. Interestingly, every cable company, as much as you've heard all their complaints about regulation, chose regulation over à la carte.

In Canada for the last 4 or 5 years, digital services have been offered à la carte. Interestingly, the cable operators wanted to offer complete à la carte. The programmers were totally against it. The Canadian Government intervened to require a basic package. And Canada is a different culture and different forces at play, they want Canada content in their basic package, but we have examples of this. For digital services we have à la carte offerings with government intervention.

I would submit that the 1992 Act was governmental intervention. They just selected regulation of price over à la carte.

Senator SUNUNU. But you can't point to a market today or an industry today where this kind of a pricing structure is mandated?

Mr. KIMMELMAN. Not where it is absolutely mandated.

Senator SUNUNU. And is the Canadian tiering structure, is that mandated by government?

Mr. KIMMELMAN. They mandate a basic tier for digital service and all the large cable operators in Canada are offering packages and à la carte, which is exactly what we're suggesting be tried here.

Senator SUNUNU. And notwithstanding the differences in culture, you might encourage us to look there at least for some lesson?

Mr. KIMMELMAN. I mean, consider the differences in culture obviously, but I would urge you to look there as an experiment. And I would also say just on Mr. Robbins' point, if what he says about Cox is accurate, I would say he's the only cable company who has not used revenue from Internet and pay services and all the digital services and put some of it away and then raised basic rates additionally beyond their investment. He'd be the only one.

Senator SUNUNU. Given the government, the drug reimportation analogy that the Chairman used, I can't help but picture a scene of people driving north of the border and then driving home with spools of cable.

[Laughter.]

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. ROBBINS. Truth be known, Senator, the Canadians come down here to find out what a good marketplace we have, what a robust marketplace we have.

The CHAIRMAN. Thank you very much. I want to thank the witnesses and point out that this is an important issue and it affects tens of millions of Americans and I think you can see by the participation of the members today that this is of great interest. And so, therefore, I know that all of you are very busy, but I do think that your time was well spent today and I think this hearing has been very helpful and I thank you.

This hearing is adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]



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